92-868

CASE NO.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1992

REPUBLIC INSURANCE GROUP, ET AL.,
Petitioners,

v.

CYNTHIA MALESKI, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA AS REHABILITATOR FOR MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Respondent.

Petition for a Writ of Certiorari to the Supreme Court of Pennsylvania

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

I. Does the Plan of Rehabilitation for an insolvent Pennsylvania insurer violate the Contract Clause of the United States Constitution where the Plan grants Petitioners more restrictive rights of setoff than they would receive as a matter of law in a liquidation and the setoff rights contained in the Petitioners' reinsurance contracts with the insolvent company?

PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

The decision of the Supreme Court of Pennsylvania, reprinted in Appendix A to this Petition, lists all parties to the proceeding in the state supreme court in the caption of that decision.

The present Petitioners are Republic Insurance Group ("Republic"), GTE Reinsurance Company, Ltd. ("GTE RE"), and Reinsurance Corporation of New York ("RECO").

Republic comprises the following insurance companies: Blue Ridge Insurance Company; Insured Lloyds; Republic Insurance Company; Republic-Vanguard Insurance Company; Republic-Vanguard Reinsurance Company; Southern County Mutual Insurance Company; Southern Guaranty Insurance Company; Southern Insurance Company; Vanguard Insurance Company; and Vanguard Underwriters Insurance Company. Each of these companies is wholly owned by Republic Financial Services, Inc.

GTE RE is wholly owned by GTE Corporation.

RECO is wholly owned by Piedmont Management Company, Inc. RECO owns a 25% share in Continental National Corporation.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT	ii
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	v
PETITION FOR A WRIT OF CERTIORARI	1
OPINIONS BELOW	1
JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	1
STATEMENT	1
A. The Petitioners' Rights of Setoff	1
B. The Mutual Fire Rehabilitation Plan's Effect on These Claims	3
C. The Pennsylvania Courts' Approval of the Setoff Restrictions	8
REASONS FOR GRANTING THE PETITION	8
I. THIS CASE INVOLVES ISSUES OF NATIONAL IMPORTANCE	8
II. THE PENNSYLVANIA COURT MISAPPLIED THE RELEVANT STANDARD FOR ADJUDGING A CONTRACT CLAUSE CLAIM IN AN INSURER INSOLVENCY PROCEEDING	10
III. MUTUAL FIRE'S REHABILITATION PLAN'S RESTRICTIONS ON REINSURERS' SETOFF RIGHTS VIOLATE THE CONTRACT CLAUSE	13

TABLE OF CONTENTS – *(Continued)*

Page

A. Petitioners' Contract Rights Are Substantially Impaired By the Plan's Setoff Provision ... 14

B. The Plan's Setoff Provisions Are a Type of Special Interest Regulation 17

CONCLUSION 20

APPENDICES

Appendix A A-1

Appendix B B-1

Appendix C C-1

Appendix D D-1

Appendix E E-1

Appendix F F-1

Appendix G G-1

TABLE OF AUTHORITIES

Cases: Page

Allendale Mutual Insurance Co. v. Melahn, 773 F. Supp. 1283 (W.D. Mo. 1991) 9, 12

Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978) 13, 14, 17, 18

Anonymous, 1 Mod. 215, 86 Eng. Rep. 837 (K.B. 1675) . 12

Beecher v. Peter A. Vogt Mfg. Co., 125 N.E. 831, 833 (N.Y. 1920) 12

Blount v. Windley, 95 U.S. 173, 177, 24 L.Ed. 424, 426 (1877) 18

Bluewater Insurance, Ltd. v. Balzano, 823 P.2d 1365, *modified and reh'g denied,* 1992 Colo. LEXIS 157 (Colo. 1992) 9, 12

Campbell v. Allegheny Corp., 75 F.2d 947, 953 (4th Cir. 1935), *cert. denied,* 296 U.S. 581 (1935) 11

Carr v. Hamilton, 129 U.S. 252 (1889) 12

Commonwealth ex rel. Sheppard v. Central Penn Nat'l Bank, 375 A.2d 874 (Pa. Commw. Ct. 1977)..... 16

Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411 (1983)..... passim

FDIC v. Liberty National Bank & Trust Co., 806 F.2d 961, 969 (10th Cir. 1986)..... 19

Forsythe v. Kimball, 91 U.S. 291 (1875) 12

Foster v. Mutual Fire, Marine & Inland Insurance Co., 1992 WL 210948 (Pa. Aug. 21, 1992)..... passim

General Motors Corp. v. Romein, 60 U.S.L.W. 4203, 4205 (1992)..... 15

Grode v. Mutual Fire, Marine & Inland Insurance Co., 572 A.2d 798 (Pa. Commw. Ct. 1990)..... passim

TABLE OF AUTHORITIES – *(Continued)*

Cases: Page

Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934) 14, 15, 17, 18

In re Midland Insurance Co., 590 N.E.2d 1186 (N.Y. 1992)..... 9, 12, 19

Melco System v. Receivers of TransAmerica Ins. Co., 105 So. 2d 43 (Ala. 1958)..... 12

Minnesota Ass'n of Health Care v. Minnesota Dep't of Public Welfare, 742 F.2d 442 (8th Cir. 1984) 16

Neblett v. Carpenter, 305 U.S. 297 (1938), *aff'g Carpenter v. Pacific Mut. Life Ins. Co.,* 74 P.2d 761 (Cal. 1937) ..... passim

Nieves v. Hess Oil Virgin Island Corp., 819 F.2d 1237, 1243 (3d Cir. 1987)..... 14, 16, 17

Scammon v. Kimball, 92 U.S. 362, 367 (1876) 12

Scott v. Armstrong, 146 U.S. 499, 511, 13 S.Ct. 48, 152, 36 L.Ed. 1059, 1063 (1892)..... 18

Stamp v. Insurance Co. of N. Am., 908 F.2d 1375 (7th Cir. 1990) (construing Illinois law), *aff'g O'Connor v. Insurance Company of N. Am.,* 622 F. Supp. 611 (N.D. Ill., 1985), *reconsideration denied,* 668 F. Supp. 1183 (N.D. Ill. 1987)..... passim

Treigle v. Acme Homestead Assn., 297 U.S. 189, 196 (1936)..... 18

United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) (Sutherland, J., dissenting)..... 13, 14, 15, 17, 20

Veix v. Sixth Ward Building & Loan Ass'n, 310 U.S. 32, 38 (1940)..... 15

W.B. Worthen Co. v. Thomas, 292 U.S. 426 (1934) 18

West Indian Co., Ltd., v. Government of the Virgin Islands, 844 F.2d 1007 (3d Cir. 1988) 15

TABLE OF AUTHORITIES – *(Continued)*

Other: Page

Whirlpool Corp. v. Ritter, 929 F.2d 1318 (8th Cir. 1991) 15

Statutes:

11 U.S.C. § 1129(a)(7)(A)(ii) 11

28 U.S.C. § 1257(a) 1

11 U.S.C.A. § 553 12

40 P.S. § 221.15(a) 3

40 P.S. 221.16(b) 16

40 P.S. 221.32 16

40 P.S. § 221. 32(a)..... passim

40 P.S. § 221.32(b) 12

40 P.S. § 221.32(b)(4) 6, 13

Treatises:

2A *Couch on Insurance 2d* § 22:28..... 11

Reinsurance, 661-62 (Robert W. Strain ed., 1987)..... 2

Articles:

Brigitte Maxey, *Coverage Seen Scant, Pricey for Storm Swept Insurers,* J. Commerce, Nov. 10, 1992 9

Derrington Semple & Robert Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer,* XXI No. 3 Tort and Insurance L.J. 407, 420 (1986)..... 10

Douglas McLeod, *U.S. Reinsurers See Vanishing Cat Capacity at Renewals but Little Change in Casualty Market,* Business Insurance, Oct. 1992, at 3..... 9

Other:

1992 *Best's Aggregate and Averages* 13 9

Brief of Appellants, May 8, 1990, at 38..... 2

TABLE OF AUTHORITIES – *(Continued)*

Cases: Page

Brief for Appellee Constance B. Foster, at 29 11

Failed Promises Report of the Subcommittee on Investigations, House Energy and Commerce Comm., 1991.. 9

The Federalist No. 44, at 301-02 (James Madison) (J. Cooke ed., 1961) 18

Grode v. Mutual Fire, Marine & Inland Insurance Co. – the Order of Dec. 8, 1986 4

Rehabilitator's Memorandum of Law in Support of Plan of Rehabilitation, Jan. 31, 1989, at 2-3..... 11

Rehabilitator's Exhibit 5; *see* Transcript at 125..... 4

Transcript of Hearing on Plan of Rehabilitation ("Transcript") at 441-42 .....2, 18

PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the approval by the Supreme Court of Pennsylvania of those sections of the Plan of Rehabilitation for the Mutual Fire, Marine and Inland Insurance Company which impair the setoff rights to which Petitioners are contractually entitled.

OPINIONS BELOW

The opinion of the Pennsylvania Supreme Court (App. A, *infra*) is officially reported at 1992 WL 210948 (Pa. Aug. 21, 1992). The opinion of the Commonwealth Court of Pennsylvania (App. B, *infra*), which the Pennsylvania Supreme Court affirmed in relevant part, is reported at 132 Pa. Commw. 196, 572 A.2d 798 (Pa. 1990).

JURISDICTION

The order of the Pennsylvania Supreme Court approving in relevant part the Plan of Rehabilitation was entered on August 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional and statutory provisions involved are set forth at App. E.

STATEMENT

A. *The Petitioners' Rights of Setoff*

Petitioners are insurance companies that entered into various reinsurance contracts with Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"), a Pennsylvania-domiciled

insurer now in rehabilitation. Under these contracts, petitioners both ceded reinsurance to, and assumed reinsurance from, Mutual Fire.[1]

This petition seeks review of the Pennsylvania Supreme Court's decision which approved a rehabilitation plan for Mutual Fire (the "Plan"), *Foster v. Mutual Fire, Marine & Inland Insurance Co.*, 1992 WL 210948 (Pa. Aug. 21, 1992), App. A, *infra*. This Plan violates Article I, § 10 of the United States Constitution by impairing Petitioners' explicit contractual rights to setoff Mutual Fire's reinsurance obligations owed to them against reinsurance obligations that petitioners owe to Mutual Fire. If this decision stands, it potentially will seriously hamper the international reinsurance market upon which much of the United States direct insurance market depends. *See infra* 8-10.

The Petitioners' contracts with Mutual Fire contain setoff clauses allowing each party to offset balances due under that specific contract, or under any other contracts between the same parties, whether on account of premiums or losses or otherwise. This is a standard clause found in most reinsurance contracts.[2] For example, numerous Republic reinsurance contracts provide:

OFFSET
ARTICLE XIII

> 1. Each party hereto shall have, and may exercise at any time and from time to time, the right to offset any balance or balances, whether on account of premiums or on account of losses or otherwise, due from such party to the other, (or, if more than one, any other)

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1. Reinsurance is a transaction whereby an insurance company (the reinsured or cedent) cedes to another insurance company (the reinsurer) a percentage of the risk the reinsured has on insurance policies issued to its policyholders in exchange for a portion of the premiums. *Reinsurance*, 661-62 (Robert W. Strain ed., 1987).

2. Specific contract provisions were not entered into the record below, but representatives clauses are appended hereto as App. G. Other evidence demonstrating Petitioners' contractual rights of setoff was entered into the record below (Transcript of Hearing on Plan of Rehabilitation ("Transcript") at 441-42; Brief of Appellants, May 8, 1990, at 38). The fact that Petitioners' contract provisions provide for setoff was not disputed by the Rehabilitator.

> party hereto under this Contract or under any other reinsurance agreement heretofore or hereafter entered into by and between them. . . .

(App. G, *infra*, G-4 – G-5). A number of GTE RE's contracts include that same clause, while others provide as follows:

> **ARTICLE XXII**
>
> **OFFSET:**
>
> Either party to this Agreement shall have the right to offset any balance or balances due the other under any or all contracts between them; and such right of deduction and offset shall be exercisable without diminution because of insolvency of the Company or Reinsurer, if such be the case.

(App. G, *infra*, G-1).

B. *The Mutual Fire Rehabilitation Plan's Effect on These Clauses*

In what was to be the nation's fourth largest insurer insolvency, the Commonwealth Court of Pennsylvania appointed the Pennsylvania Insurance Commissioner as the Rehabilitator of Mutual Fire pursuant to Section 515 of the Insurance Department Act of 1921, 40 P.S. § 221.15(a) (1992).

In 1989, the Rehabilitator proposed a Plan of Rehabilitation. Petitioners and others filed timely objections to the Plan. In their objections, Petitioners claimed that the setoff provisions violated their contract rights under the Contract Clause and denied them the rights and value they would have received in a liquidation as provided for in this Court's decision, *Neblett v. Carpenter*, 305 U.S. 297 (1938). On January 23, 1990, the Commonwealth Court rejected Petitioners' constitutional arguments and approved the Plan with certain modifications not challenged here. *Grode v. Mutual Fire, Marine & Inland Insurance Co.*, 572 A.2d 798 (Pa. Commw. Ct. 1990), App. B, *infra*. Under the Plan, reinsurers such as Petitioners will provide over $500 million to Mutual Fire, which is upwards of

95% of the funds to be collected under the Plan; while the reinsurers are seeking to offset less than 10% of this amount (Rehabilitator's Exhibit 5; see Transcript at 125).

Section III of the Plan addresses the right of setoff (App. F, infra, F-2 – F-4). The "preamble" to this section expressly states that *"[r]egardless of any provision in a reinsurance agreement,* mutual debts and credits between Mutual Fire and other persons may be setoff on the following basis: . . ." (emphasis added) *Id* at F-2. By this preamble, all of petitioners' contractual agreements on setoff were rendered null and void.

Section III then sets forth two setoff definitions which may be utilized by reinsurers. Section III(D), as modified by the Commonwealth Court, provides that "[t]he only mutual debts and credits that may be setoff against one another are those Due and Owing on December 31, 1986." (App. F, *infra*, F-3).[3] "Due and Owing" is defined under the Plan as "reinsurance recoverable on paid Losses, paid Loss Adjustment Expenses, Claim settlements and reimbursement agreements." Section I, Definitions, No. 11, at 2 (App. F, *infra*, F-2). Under Section III(D), the only reinsurance obligations subject to setoff are reinsured losses and loss adjustment expenses which were paid as of December 31, 1986 (App. F, *infra*, F-3).

This provision bars a setoff for the vast bulk of the claims owed by reinsurers which occurred prior to Mutual Fire's insolvency. Generally, the reinsurer is not liable to the reinsured until the reinsured has actually paid a claim to the insured, and under most liability policies, the losses are not paid until many years after they have occurred. Reinsurers will have to pay 100 cents on the dollar for obligations which occurred prior to December 31, 1986, even where those obligations are

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3. Section III(D), as modified, is unclear because on the one hand it provides that "setoff for purposes of this Plan shall be calcualted as of December 4, 1986," but then goes on to provide that only obligations due and owing as of December 31, 1986, may be setoff. (App. F, *infra*, F-3). It is unclear why December 31, 1986, was chosen except that it was year end. December 4, 1986, is the date that the Pennsylvania Insurance Department petitioned the Pennsylvania Commonwealth Court to place Mutual Fire into rehabilitation. On December 8, 1986, the Commonwealth Court issued an order of rehabilitation for Mutual Fire. App. C, *infra*.

not fixed until many years thereafter,[4] while they will only have a claim as an unsecured creditor for the same types of obligations owed to them by Mutual Fire as their reinsurer. Thus, the limitation as to losses which were actually paid by December 31, 1986, dramatically decreases the petitioners' setoff rights.

Section III(E) of the Plan provides for an optional setoff definition which is available to certain reinsurers of Mutual Fire which both reinsured and were reinsured by Mutual Fire[5] (App. F, infra, F-3 – F-4). Under this definition, the Petitioners may take an offset for the amounts that Mutual Fire owed them as their reinsurers for "Due and Owing" amounts, "reported IBNR," and "reported Case Reserves . . . calculated as of December 4, 1986" (App. F, *infra,* F-4).[6] However, if this amount exceeds what the Petitioners owe Mutual Fire (where the Petitioners reinsured Mutual Fire) for Due and Owing amounts and Case Reserves computed as of December 4, 1986, then

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4. By virtue of the standard insolvency clause in the reinsurance contracts, Petitioners will have to indemnify Mutual Fire for the amounts for which Mutual Fire would have been liable had it not been insolvent. For example, if a judgment of $1 million is rendered against Mutual Fire and that class of policyholders is only receiving 50 cents on the dollar for their claims, Petitioners will have to pay reinsurance as if Mutual Fire had paid $1 million. This is not contested by Petitioners.

5. By agreement with the Rehabilitator, Petitioner Republic has at least the right to this setoff option and is to receive any more favorable right that it may be accorded through this Court or otherwise. While Petitioners RECO and GTE RE do not have such an agreement with Mutual Fire, their position is that they should be accorded at least the setoff available under the optional definition.

6. "Case Reserves" and "IBNR" involve losses which occurred prior to December 4, 1986, but which were not paid until thereafter. "Case Reserves" refer to losses where the insurer has been advised of the loss by December 4, 1986, but where the amount has not been fixed as of that date. "IBNR" refers to losses which occurred prior to December 4, 1986, but where the insurer does not have actual knowledge of the loss prior to that date. For example, insurers which issued liability policies decades ago are just being notified of environmental, asbestos and other latent injury claims on those policies. Insurers regularly set aside amounts for IBNR and Case Reserves, and these amounts are calculable based upon actuarial and historical analyses.

Petitioners' total setoff is limited to this amount of reinsurance recoverables owed to Mutual Fire. Section III(E)(2)(b), App. F, infra, F-4.[7].

While the convoluted wording of the Plan's optional setoff definition renders its meaning unclear, it apparently would abrogate Petitioners' setoff rights in two ways. First, it sets a limit on the total amount of setoff available to Petitioners regardless of the amount of the actual balances. See Section III(E)(2), App. F, infra, F-4. Second, the setoff for IBNR and Case Reserves is limited by the requirements that they must be "reported" and "computed as of December 4, 1986." Section III(E)(2)(a), App. F, infra, F-4.

The "computed" requirement seems to require that IBNR and Case Reserves be valued based upon information known as of December 4, 1986. This will result in a completely inaccurate valuation of the obligations represented by the reserves. For both IBNR and Case Reserves, the event resulting in liability has occurred prior to December 4, 1986, but the liquidation of the amount will not occur until later. With the passage of time, the insurer will get a better understanding of the true amount of these liabilities. Hence, by binding Petitioners' offsets to the amounts reserved at December 4, 1986, the Plan requires the use of inherently inaccurate numbers. Moreover, given the dramatic increases in insurers' potential exposures since 1986 in environmental and other toxic tort claims, those 1986 valuations are most likely dramatically understated. This is an attempt by the Rehabilitator to reduce Petitioners' offset rights. Nowhere in the parties' offset clauses or applicable law is there provision for

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7. The Plan may also preclude Petitioners from taking a setoff for premium owed to them by Mutual Fire. Petitioners' contracts allow for, this setoff. *See, e.g.*, App.G., *infra*. The Commonwealth Court in a separate opinion denying Petitioners' request for a stay of implementation of the Plan (Memorandum and Order dated March 27, 1990 App. D. *infra*, D-4), held that Petitioners could not take a setoff for this premium in spite of the language of the statute which does not prevent this setoff. 40 P.S. § 221.32(b)(4), App. E, *infra*, E-1. The Pennsylvania Supreme Court did not address this issue even though Petitioners raised it in their appeal. *See Foster v. Mutual Fire, Marine & Inland Insurance Co.*, 1992 WL 210948 (Pa. Aug. 21, 1992), App. A, *infra*.

this requirement for utilizing a procedure which ensures an inaccurate valuation of obligations.[8] *See* App. G, *infra,* G-1 – G-2 and G-4 – G-5. The Rehabilitator's solution to the possibility of its reserves being overstated was one-sided – if its own valuation of case reserves was ultimately determined to be excessive, the reinsurer's offset amount would be decreased retroactively, and the reinsurer would pay the difference. Section III(E)(2)(b), App. F, *infra,* F-4. There is certainly nothing in the parties' contracts or law which permits retroactive revaluation for one party's debts but not for the others. See App. G and 40 P.S. § 221. 32(a), App. E. The Rehabilitator's inclusion of this provision in its Plan shows she recognized the problem of valuing reserves in 1986 – her means of resolving it, however, has no equitable, contractual or legal basis therefor.

The "reported" requirement of Section III(E) is not defined under the Plan and also is unclear. App. F, *infra,* F-4. The Rehabilitator has apparently argued that if IBNR or Case Reserves were not reported to Mutual Fire as of December 4, 1986, then, a setoff cannot be taken for these obligations. However, Petitioners (and other reinsurers) are not required to report IBNR to Mutual Fire under their reinsurance contracts, and so reinsurers often do not report these amounts. Hence, if the Rehabilitator's argument is correct, this renders any offset for IBNR illusory at best. Moreover, reinsurers most likely did not calculate IBNR and Case Reserves on December 4, 1986, and report it on that date. Therefore, to the extent there was any reporting, it would likely have been done much earlier which renders the numbers even more inaccurate.

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8. While for purposes of finality it may be necessary to fix a valuation date, there is no legal, contractual, or logical rationale to use December 4, 1986, as that date. December 4, 1986, is only relevant as the date for determining whether obligations have occurred before or after the petition for rehabilitation. *See Stamp v. Insurance Co. of N. Am.,* 908 F.2d 1375, 1380 (7th Cir. 1990). While pre-petition debts may not be setoff against post-petition debts, there is no requirement that the valuation of the debts be according to pre-petition numbers. *See id.* At a minimum, the Rehabilitator could have asked Petitioners to submit their Case Reserves and IBNR, with supporting documentation, by a certain date and have bound them to those figures.

C. *The Pennsylvania Court's Approval of the Setoff Restrictions*

On January 23, 1990, the Commonwealth Court approved the Rehabilitation Plan with certain modifications and rejected the Petitioners' Contract Clause challenges to the setoff provisions. *Grode,* 572 A.2d at 805, 812, App. B, *infra,* B-8 – B-9. In Petitioners' timely appeal to the Pennsylvania Supreme Court, Petitioners asserted their constitutional challenge under the Contract Clause. *See Foster v. Mutual Fire, Marine & Inland Insurance Co.,* 1992 WL 210948, at *7 (Pa. Aug. 21, 1992), App. A, *infra,* A-13 – A-14.

The Pennsylvania Supreme Court rejected the Petitioner's Contract Clause claim under *Neblett,* 305 U.S. 297. Foster, 1992 WL 210948, at *19 n.4, App. A, *infra,* A-11 – A-12. Next, in a two-paragraph footnote, the court dispensed with Petitioners' objections regarding contractual setoff rights, applying the three standards set forth in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.,* 459 U.S. 400, 411-413 (1983). *Foster,* 1992 WL 210948, at *19 n.4, App. A., *infra,* A-13 – A14 n.4. Without discussing the effect of the Plan on those contractual provisions, the court affirmed the Commonwealth Court's conclusion that the impairments were insubstantial. *Id.* The court then stated the Plan was permissible in light of Pennsylvania's significant interest in regulating the fiscal affairs of its insurers for the public welfare even if impairments existed. *Id.* Finally, the court noted that petitioners "are members of a highly regulated industry and as such were well aware of the powers of a Rehabilitator." *Id.* The court did not, however, cite any Pennsylvania statute or decision that specifically grants Rehabilitators the power to limit setoff provisions in reinsurance contracts. *Id.*

REASONS FOR GRANTING THE PETITION

I. THIS CASE INVOLVES ISSUES OF NATIONAL IMPORTANCE

This case involves the extent to which a rehabilitation plan for an insolvent insurer can abrogate setoff provisions contained

in reinsurance contracts and deny reinsurers the equivalent rights they would receive in a liquidation.

The oft-litigated issue of setoff[9] is of critical importance to the insurance/reinsurance industry and to the willingness of both domestic and foreign reinsurers to continue providing reinsurance to U.S. insurers. As is demonstrated by the recent devastation caused by hurricanes Andrew and Iniki, the United States is dependent on a large and solvent insurance capacity. Douglas McLeod, *U.S. Reinsurers See Vanishing Cat Capacity at Renewals but Little Change in Casualty Market,* Business Insurance, Oct. 1992, at 3; Brigitte Maxey, *Coverage Seen Scant, Pricey for Storm Swept Insurers,* J. Commerce, Nov. 10, 1992, at 9A. It is the continuing willingness of reinsurers to provide the reinsurance which creates and increases this capacity. In these days of a dramatically shrinking international reinsurance capacity, it is important to ensure that no unconstitutional restrictions are placed on the application of standard bargained-for provisions which are at the heart of most reinsurance contracts.

Reinsurance is a huge international market. In 1991, U.S. insurers paid in excess of $30 billion in reinsurance to some 139 reinsurers. 1992 *Best's Aggregate and Averages* 13. In recent years, insolvencies of insurers have significantly increased. *See Failed Promises,* Report of the Subcommittee on Investigations, House Energy and Commerce Comm., 1991, at 2. Because of these increased insolvencies and the shaky international financial climate, reinsurers are far more concerned about how their rights will be affected in cases of insolvency. Given the Plan's provision that the reinsurance contracts' clauses may be ignored, there is no way for reinsurers to protect themselves if this decision becomes the law of the land.

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9. *See In re Midland Insurance Co.,* 590 N.E.2d 1186 (N.Y. 1992); *Stamp v. Insurance Co. of N. Am.,* 908 F.2d 1375 (7th Cir. 1990) (construing Illinois law), *aff'g O'Connor v. Insurance Company of N. Am.,* 622 F. Supp. 611 (N.D. Ill., 1985), *reconsideration denied,* 668 F. Supp. 1183 (N.D. Ill. 1987); *Bluewater Insurance, Ltd. v. Balzano,* 823 P.2d 1365, *modified and reh'g denied,* 1992 Colo. LEXIS 157 (Colo. 1992); *see also Allendale Mutual Insurance Co. v. Melahn,* 773 F. Supp. 1283 (W.D. Mo. 1991).

The Pennsylvania Court's decision hinders the maintenance of this international reinsurance market upon which practically all direct insurers depend. Reinsurers that cannot invoke setoff clauses, for which they bargained with sophisticated insurance companies, are far less likely to assume reinsurance from any but the largest and most highly rated insurers. *See Stamp v. Insurance of N. Am.*, 908 F.2d 1375, 1380 (7th Cir. 1990); Derrington Semple & Robert Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer,* XXI No. 3 Tort and Insurance L.J. 407, 420 (1986). This could result in a further contraction of the reinsurance capacity for U.S. insurers and, concomitantly, in a contraction in insurance capacity. This case affords an opportunity for this Court to clarify an important constitutional and contractual right affecting reinsurers. More broadly, review here would correct the misapplication by lower courts of the appropriate standards for evaluating Contract Clause objections to reorganization plans involving firms in regulated industries. To allow Pennsylvania to deprive reinsurers of their rights in this fashion, with the resulting damage to the worldwide insurance/reinsurance industry, can only lead to other states' attempting to abrogate reinsurers' bargained-for contract rights in a similar fashion – restricting markets, increasing the cost of reinsurance and ultimately increasing the costs of insurance for all insureds.

II. THE PENNSYLVANIA COURT MISAPPLIED THE RELEVANT STANDARD FOR ADJUDGING A CONTRACT CLAUSE CLAIM IN AN INSURER INSOLVENCY PROCEEDING

The Pennsylvania Supreme Court refused to apply this Court's decision in *Neblett,* 305 U.S. 297, in evaluating petitioners' Contract Clause claims. *Foster v. Mutual Fire, Marine & Inland Insurance Co.,* 1992 WL 210948, at *7 (Pa. Aug. 21, 1992), App. A, *infra,* A-11 – A-12. Instead, it wrongly assumed that only this Court's *Energy Reserves* decision, 459 U.S. 400, provided the relevant guidance. Foster, 1992 WL 210948, at *19 n.4.

In *Neblett,* this Court held that a plan of rehabilitation must be fair and accord creditors and policyholders at least the same rights and value for their claims they would have received under a liquidation. *Neblett,* 305 U.S. at 305, *aff'g Carpenter v. Pacific Mut. Life Ins. Co.,* 74 P.2d 761 (Cal. 1937).[10] *Neblett* involved a challenge to a plan of rehabilitation of a California-domiciled insurance company. Dissenting policyholders claimed, *inter alia,* that the rehabilitation plan impaired their rights under the Contract Clause. *Id.* In *Carpenter,* the California Supreme Court held that a dissenter to a rehabilitation plan, "is entitled to . . . the equivalent of what he would receive on liquidation." *Carpenter,* 74 P.2d at 778. The United States Supreme Court affirmed the California Supreme Court's approval of the plan because the plan provided dissenting policyholders with the option of receiving the equivalent rights they would have received under a liquidation. *Neblett,* 305 U.S. at 305. *See also* 2A *Couch on Insurance 2d* § 22:28 ("[A]ll the law requires is that the party receive the liquidated value of his contract rights without any reasonable delay. All that such a dissenter is entitled to in case of rehabilitation is the equivalent of what he would receive on liquidation.").[11]

Accordingly, for this Plan to satisfy the Constitutional guarantees enunciated in *Neblett,* the Plan must provide the

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10. The Rehabilitator conceded that this was the correct standard by which to judge the Plan but claimed that the Plan complied with the standard. Rehabilitator's Memorandum of Law in Support of Plan of Rehabilitation, Jan. 31, 1989, at 2-3; Brief for Appellee Constance B. Foster, at 29. In spite of the Pennsylvania Supreme Court's discussion of the broad discretion allowed the Rehabilitator and the lower court, the Pennsylvania Supreme Court inexplicably concluded that *Neblett* did not apply. *Foster,* 1992 WL 210948, at *7, App. A, *infra,* A-11.

11. It is a well established principle in the area of insolvency reorganization that creditors must receive as much in a plan that compromises and restructures debts as they would in a liquidation of the debtor. *See, e.g., Campbell v. Allegheny Corp.,* 75 F.2d 947, 953 (4th Cir. 1935), *cert. denied,* 296 U.S. 581 (1935) (the creditor has the right "to require that the amount paid in satisfaction shall be substantially as great a pro rata share of the property possessed by the debtor or as it can pay, or can reasonably be expected to pay"). This principle has been codified in the Bankruptcy Code at 11 U.S.C. § 1129(a)(7)(A)(ii).

creditors of Mutual Fire with at least the value and rights they would receive in a liquidation. *Neblett,* 305 U.S. at 305. Had liquidation been ordered, petitioners would have enjoyed the greater setoff rights provided for in 40 P.S. § 221.32(a), which is found in the liquidation sections of the Pennsylvania insurance code (App. E, *infra,* E-1). This statute mandates that "mutual debts or mutual credits[12] between the [liquidated] insurer and another person . . . be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).[13] Under this standard, petitioners would have been allowed to offset fully Case Reserves and IBNR on Mutual Fire's obligations to them against their obligations owed to Mutual Fire. These are "mutual" obligations because they all occurred prior to the rehabilitation petition and because they are owed between the same parties acting in the same capacity. *See* 40 P.S. § 221.32(a); *see also In re Midland Insurance Co.,* 590 N.E.2d 1186 (N.Y. 1992); *Stamp v. Insurance Co. of N. Am.,* 908 F.2d 1375 (7th Cir. 1990) (construing Illinois law), *aff'g O'Connor v. Insurance Company of N. Am.,* 622 F. Supp. 611 (N.D. Ill., 1985), *reconsideration denied,* 668 F. Supp. 1183 (N.D. Ill., 1987). *But see Melco System v. Receivers of TransAmerica Ins. Co.,* 105 So. 2d 43 (Ala. 1958); *Bluewater Insurance Ltd. v. Balzano,* 823 P.2d 1365, modified and reh'g denied, 1992 Colo. LEXIS 157 (Colo. 1992). *Allendale Mutual Insurance Co. v. Melahn,* 773 F. Supp. 1283 (W.D. Mo. 1991).

The Pennsylvania Supreme Court below simply ignored *Neblett,* even though both *Neblett* and this case involved a

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12. Judge Cardozo formulated the accepted definition of mutality; "To be mutual, [the debts and credits] must be due to and from the same persons in the same capacity." *Beecher v. Peter A. Vogt Mfg. Co.,* 125 N.E. 831, 833 (N.Y. 1920). The federal bankruptcy code preserves the rights of parties to setoff mutual debts and credits in a bankruptcy. 11 U.S.C.A. § 553. This Court has recognized the right of setoff since the 19th century. *Forsythe v. Kimball,* 91 U.S. 291 (1875); *see also Scammon v. Kimball,* 92 U.S. 362, 367 (1876) and *Carr v. Hamilton,* 129 U.S. 252 (1889). English law has recognized the right of setoff at least since 1675. *Anonymous,* 1 Mod. 215, 86 Eng. Rep. 837 (K.B. 1675).

13. Subsection (b) of the statute is inapplicable to Petitioners' rights to setoff mutual debts and credits with Mutual Fire. *See* 40 P.S. § 221.32(b), App. E, *infra,* E-1.

Contract Clause challenge to a rehabilitation plan for an insolvent insurer. *See Foster,* 1992 WL 210948, at *7, App. A., *infra,* A-12. No subsequent decision of this Court has overruled, criticized, or questioned *Neblett;* and neither *Energy Reserves* nor later decisions negate its application to Contract Clause attacks on an insolvent insurer's plan of rehabilitation. *See Energy Reserves,* 459 U.S. 400.

Moreover, although the Pennsylvania Court deemed *Neblett* irrelevant where Petitioners argued that they would have had the right to offset Case Reserves and IBNR in a liquidation, that court relied on *Neblett* and the Pennsylvania liquidation statute as justification for its rejection of Petitioner's claim to setoff debts Mutual Fire owed them against premium they owed Mutual Fire. *Foster,* 1992 WL 210948, at *9, App. A, *infra,* A-15 – A-16. In order to reach this result, the Pennsylvania Court expressly relied on 40 P.S. § 221.32(b)(4) and held that, since petitioners could fare no better in a liquidation proceeding, they had no valid constitutional objection. *Foster,* 1992 WL 210948, at *9, App. A, infra, A-15 – A-16. The court below provided no explanation as to why the *Neblett* standard was applicable to foreclose some setoff rights, but had no application to assure setoff rights that would be available in a liquidation. The only thing consistent about the Pennsylvania Court's decision is that it ruled for the Rehabilitator and against the insurance industry on each provision.

This failure to apply the proper standard to all of the Plan's restrictions on petitioners' contractual setoff rights warrants either summary reversal or vacatur, or review by this Court on the merits.

III. MUTUAL FIRE'S REHABILITATION PLAN'S RESTRICTIONS ON REINSURERS' SETOFF RIGHTS VIOLATE THE CONTRACT CLAUSE

The same result is reached based upon an analysis of the provisions contained in Petitioner's contracts with Mutual Fire and this Court's modern analysis of the Contract Clause. *See Energy Reserves,* 459 U.S. 400; *Allied Structural Steel Co. v. Spannaus,* 438 U.S. 234 (1978); *United States Trust Co. v. New*

Jersey, 431 U.S. 1 (1977); *see also Home Building & Loan Ass'n v. Blaisdell,* 290 U.S. 398 (1934) (Sutherland, J., dissenting).

This Court has established a three-prong analysis for deciding Contract Clause challenges to state law impairing private contract rights. First, where there is a contractual relationship, it must be determined whether the law has operated "as a substantial impairment of a contractual relationship." *Energy Reserves,* 459 U.S. at 411 (quoting *Allied Structural Steel Co.,* 438 U.S. at 244). If this threshold test is met, the Court then determines whether the government has a "significant and legitimate public purpose behind the regulation . . . such as the remedying of a broad and general social or economic problem." *Energy Reserves,* 459 U.S. at 411-12. If there is such a purpose, the state must also show that the adjustment of the parties' contractual rights is based upon reasonable conditions and is of a character appropriate to a public purpose. *Id.* at 412; *see United States Trust Co.,* 431 U.S. at 22; *Nieves v. Hess Oil Virgin Island Corp.,* 819 F.2d 1237, 1243 (3d Cir. 1987).

A. *Petitioners' Contract Rights Are Substantially Impaired by the Plan's Setoff Provision*

Petitioners' contracts with Mutual Fire provide without limitation that balances owing between the parties will be setoff and, in some cases, specifically provide for the preservation of this right in an insolvency context. *See* App. G, *infra*, G-1 – G-2, G-4 – G-5. While the law is that Petitioners can not take a setoff for insured losses which occurred after the rehabilitation date, the Plan goes much further than that. *See Stamp*, 908 F.2d at 1380. As discussed, *supra* at 2-8, Petitioners as Mutual Fire's reinsurers must continue to pay out 100 cents on the dollar on occurrences which occurred prior to Mutual Fire's rehabilitation, but which are paid later. And, yet, when it is Mutual Fire that is the reinsurer, the petitioners' offset rights are extremely limited as respects claims which occurred prior to Mutual Fire's rehabilitation and are paid later. Instead, the Plan largely overrides the reinsurance contracts' setoff provisions and forces petitioners to collect only a minuscule percentage of their claim

for millions of dollars as general unsecured creditors. This is a blatant violation of the Contract Clause.

Additionally, the court below was incorrect in holding that the Pennsylvania setoff statute, 40 P.S. § 221.32(a), does not apply under this Court's Contract Clause cases. Laws in existence at the inception of a contract affecting the validity, construction and enforcement of contracts are considered part of the contract's terms and protected pursuant to the Contract Clause. *General Motors Corp. v. Romein*, 60 U.S.L.W. 4203, 4205 (1992); *United States Trust Co. v. New Jersey*, 431 U.S. 1, 19-20 n.17 (1977). *See also Home Building & Loan Ass'n*, 290 U.S. at 429-30 (laws which exist at the time of the making of the contract are incorporated into the contract terms). Pennsylvania statute 40 P.S. § 221.32(a) was enacted in 1977, and all of the Petitioners' contracts with Mutual Fire became effective after that date. In a rehabilitation, parties must be accorded equivalent rights to what they would receive in a liquidation. Thus, the degree of setoff allowed under that statute should be accorded to Petitioners under the Contract Clause. The Plan's setoff provisions, as discussed, deny Petitioners those rights.

The court below, with little analysis, found that the Petitioners' contract rights were not substantially impaired because they participated in an extensively regulated industry. *Foster,* 1992 WL 210948, at *19 n.4, App. A, *infra*, n. 4, A-13 – A-14. While Pennsylvania does regulate insurer insolvencies, that is not, however, the end of the inquiry. The Court must consider the extent to which the State had previously regulated, in this case, setoff rights "in the particular." *Veix v. Sixth Ward Building & Loan Ass'n*, 310 U.S. 32, 38 (1940). *See Energy Reserves,* 459 U.S. at 413-416.[14]

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14. In a number of circuit court decisions, contract clause challenges have been upheld involving regulated industries. These cases focused on the particular regulation at issue and whether this facet of the parties' contractual relationship had been subject to previous regulation. *Whirlpood Corp. v. Ritter*, 929 F.2d 1318 (8th Cir. 1991) (contracting parties have a right to rely on existing law, so that the retrospective application of an Oklahoma statute which changed who were the beneficiaries of death benefits on life insurance contracts unconstitutionally altered the expectations and obligations of the parties); *West Indian Co., Ltd., v. Government of the Virgin Islands*, 844 F.2d

The Pennsylvania Court referred to the broad powers accorded rehabilitators of which petitioners should be presumed cognizant when they contracted with Mutual Fire. *Foster*, 1992 WL 210948, at *19 n.4, App. A, *infra*, A-9 - A-11. Yet, other than 40 P.S. § 221.32, which mandates setoff in liquidations (and under the Contract Clause in a rehabilitation), no Pennsylvania statute, regulation or prior decision purported to regulate, let alone limit, the rights of reinsurers to setoff reinsurance recoverables owed by the insolvent insurer in a rehabilitation. In fact, other than the instant decision, the one opinion in an insurer insolvency context cited by the Pennsylvania Court, *Foster*, 1992 WL 210948, at *8, App. A, *infra*, A-15, was *Commonwealth ex rel. Sheppard v. Central Penn Nat'l Bank*, 375 A.2d 874 (Pa. Commw. Ct. 1977). There the court actually upheld the contractual right of a bank to claim setoff as an affirmative defense when it was sued by a liquidator of an insolvent insurer. *Id.*[15]

Indeed, Pennsylvania's only statutory provision mandates setoff in a liquidation and, in Petitioners' view, in a rehabilitation. *See* 40 P.S. § 221.32(a), App. E, *infra*. Thus, the only regulation that exists should guarantee the Petitioners the right to setoff mutual debts and credits. The reinsurers' legitimate expectation when they entered into their contracts with Mutual

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NOTES *(Continued)*

1007 (3d Cir. 1988) (the severity of an impairment of contract rights caused by repeal of a grant of dredging rights in a coastal zone was not lessened by the fact that the coastal zone area was heavily regulated); *Nieves v. Hess Oil Virgin Islands Corp*, 819 F.2d 1237, 1247-48 (3d Cir.1987) (worker's compensation statute that abolished the "borrowed employee" defense in pending cases was held violative, because although the employer was aware that "certain aspects" of worker's compensation law were subject to change, it had "no reason to anticipate" a drastic, retroactive change in the law); *Minnesota Ass'n of Health Care v. Minnesota Dep't of Public Welfare*, 742 F.2d 442 (8th Cir. 1984) (although nursing homes could reasonably expect rate regulation, a Minnesota statute went too far "because it disrupts settled and completed financial arrangements under contracts made in reliance on existing law").

15. Like most states, Pennsylvania grants rehabilitatiors only the same contractual rights as the company's into whose shoes they step, absent an overriding statute. *See e.g., Commonwealth ex rel. Sheppard, supra; see also* 40 P.S. 221.16(b) (granting rehabilitators the powers of the insurer's directors, officers, and managers).

Fire was that their setoff rights would be preserved in a rehabilitation under the state law. *See Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 429-30 (1934); *see also Nieves v. Hess Oil Virgin Islands Corp.*, 819 F.2d 1237, 1248 (3d Cir. 1987). The absence of any provisions in Pennsylvania statutes or caselaw that had previously denied or limited the specific setoff rights which petitioners are claiming, and indeed a statute which guarantees those rights, renders the Mutual Fire Plan just as much of a "sudden, totally unanticipated and substantial retroactive obligation," *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 249 (1978), as the Minnesota law invalidated there.

B. *The Plan's Setoff Provisions are a Type of Special Interest Regulation*

Under *Energy Reserves,* the burden is then shifted to the Rehabilitator to prove that the substantial impairment of contract rights she seeks is for a "significant and legitimate public purpose . . . such as the remedying of a broad and general social or economic problem." *Energy Reserves*, 459 U.S. at 411-12. The Rehabilitator failed to make any showing that the Plan serves a legitimate public purpose. *See Foster*, 1992 WL 210948, at *19 n.4, App. A, *infra*, A-12 – A-13. The court below accepted this conclusion without any analysis whatsoever. *Id*. Mere unsupported statements that a regulation serves a public purpose should not be sufficient to satisfy this burden.

In fact, the Plan is inherently not legislation to remedy a broad societal ill. At issue here is not an amendment to the Pennsylvania Insurance Code either to restrict setoff rights of reinsurers generally or to grant all rehabilitators the power to reject all reinsurance contracts that contain setoff clauses. Rather, the challenged provisions of the Plan, like the offensive statutes in *Allied Structural Steel Co.*, 438 U.S. at 244, and *United States Trust Co.*, 431 U.S. at 22, are expressly directed at Petitioners' contracts. *See* Section III, App. F, *infra*. The Plan holds no benefits for insureds in Pennsylvania generally, only arguably for a minority of those who had obtained insurance from Mutual Fire. *Cf. Allied Structural Steel Co.*, 438 U.S. at

250.[16] The Plan's setoff restrictions deprive reinsurers of their rights of setoff only to increase the money in the estate to pay the claims of a discrete group of Mutual Fire's policyholders. Indeed, the Special Deputy Rehabilitator admitted below that this was the purpose of the setoff provisions. (Transcript, at 86, 201-202). The Pennsylvania Court ignored this admission.

As long ago as its seminal analysis in *Blaisdell*, 290 U.S. 398, this Court has held that impairments caused by laws favoring special interests offend the Contract Clause. *See also W.B. Worthen Co. v. Thomas*, 292 U.S. 426 (1934); *Treigle v. Acme Homestead Assn.*, 297 U.S. 189, 196 (1936) (modification of existing withdrawal rights of members of building and loan association invalid where law relegated members to lowest priority of distribution and eliminated reserve requirements to pay their claims) (*cited in Allied Structural Steel Co.*, 438 U.S. at 243).

Indeed, the effect of the challenged restrictions will be conversely to harm the public interest, while benefiting only one group of creditors. Both federal and state appeals courts have recognized the public policies served by enforcing setoff rights. First, doing so fulfills the contracting parties' expectations and affords certainty and predictability to contracts—precisely the values at the core of the Contract Clause. *See Allied Structural Steel Co.*, 438 U.S. at 245; *see also The Federalist* No. 44, at 301-02 (James Madison) (J. Cooke ed., 1961).[17]

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16. Only a segment of Mutual Fire's policyholders are the intended beneficiaries of the abrogation of Petitioners' rights because claims of many policyholders are paid by the appropriate state guaranty insurance funds to the extent allowed. Moreover, the vast majority of Mutual Fire's insureds were commercial insureds that have more resources than the typical consumer.

17. Courts have long recognized the importance of parties' reliance on enforcement of their contractual setoff rights:

> The preferential aspect of setoff has long been understood to be justified by the inequity inherent in requiring those who have dealt with insolvents to pay their debts in full while receiving only a fraction of their claims in return. *Blount v. Windley*, 95 U.S. 173, 177, 24 L.Ed 424, 426 (1877). "The equity of equality among creditors is either found inapplicable to such setoffs or yields to their superior equity," *Scott v. Armstrong*, 146 U.S. 499, 511, 13

Second, these provisions, as both the Seventh Circuit and New York Court of Appeals have pointed out, provide reinsurers with a form of security for their claims thereby increasing reinsurance capacity and lowering premiums. As Judge Easterbrook wrote in upholding the applicability of setoff clauses in an insurance insolvency:

> It would hamper the utility of reinsurance pools, and so increase the cost of insurance, if bankruptcy not only carved a pool into pre- and post-filing portions but also broke up the offset for casualties occurring before the filing. Offsetting debts in a reinsurance pool not only spreads risk but also acts as mutual security for performance. Such security is especially important for smaller insurers; if the large firms could not count on the netting of balances to satisfy obligations, they would be more likely to exclude smaller or tottering firms making new entry harder and precipitating failures of firms in difficulty. With a mutual offset inside the pool, each party's desire to realize on its own claims against the pool gives it an incentive to keep the pool going. If the instant one member fails the other members' exposure becomes the gross rather than the net obligation, then the mutual security of the offsetting debts is destroyed. Pools become less useful; the premium charged to bear risk will rise. (citations omitted).

Stamp, 908 F.2d at 1380; *see also Midland*, 590 N.E.2d 1186. Most of Mutual Fire's reinsurers are also in the direct insurance business. The adverse financial impact of the Plan's restrictions on setoff will limit their ability to provide insurance to consumers.

Even if this Court decided there was a legitimate public purpose justifying the setoff restrictions, there was no showing

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S.Ct. 48, 152, 36 L.Ed. 1059, 1063 (1892). *The equities favoring setoff are especially strong when the parties have dealth with each other in reliance on the mutual credits existing between them.* *FDIC v. Liberty National Bank & Trust Co.*, 806 F.2D 961, 969 (10th Cir. 1986) (emphasis added).

that the setoff provision was a finely tuned adjustment of the parties' rights. *See United States Trust Co.*, 431 U.S. 1. Favoring one discrete group over another group cannot be a fine tuning of rights. *See id.*

CONCLUSION

The petition for the writ of certiorari should be granted.

Respectfully submitted,

David M. Rain

Counsel for Petitioners

APPENDIX A

IN THE
SUPREME COURT OF PENNSYLVANIA

MIDDLE DISTRICT

CONSTANCE B. FOSTER, Insurance Commissioner of the Commonwealth of of Pennsylvania	: Nos. 28 and 71 M.D. : Appeal : Dockets 1989 and : Nos. 15 thru 24 M.D. : Appeal :
v.	: Appeal from the Orders of the : Commonwealth Court dated : March 17, 1989, November 22, : 1989, and January 23, 1990 : at No. 3483 CD 1986.
THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY	: : :
APPEAL OF: Committee of Policyholders at Nos. 28/71 1989	: : : :
APPEAL OF: Colonial Penn Group, Inc. at No. 15/90	: : : :
APPEAL OF: Allstate Insurance Company at No. 16/90	: : : :
APPEAL OF: AIG Risk Management, et al. at No. 17/90	: : : :

APPEAL OF: Pepsi-Cola Bottling Co. of Charlotte, Inc., et al. No. 18/90	:	
APPEAL OF: Fireman's Fund Insurance Co. and Interstate Fire and Casualty Co. at No. 19/90	:	
APPEAL OF: Committee of Policyholders at No. 20/90	:	
APPEAL OF: Evanston Insurance Co. at No. 21/90	:	
APPEAL OF: RLI Insurance Co. at No. 22/90	:	
APPEAL OF: PA. Insurance Guaranty Assn. (PIGA) at No. 23/90	:	132 Pa. Commw. Ct. 196 572 A.2d 798 (1990)
APPEAL OF: The Member Companies of The Republic Insurance Group, et al. at No. 24/90	:	ARGUED: May 8, 1990 DECIDED: August 21, 1992

OPINION

NIX, C.J.

This is an appeal from the Order of the Commonwealth Court modifying, and then approving, a Rehabilitation Plan ("Plan") for Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire") submitted by Appellee, Constance Foster, Insurance Commissioner of the Commonwealth of Pennsylvania ("Commissioner or Rehabilitator"), pursuant to Section 515(a) of Article V of the Act of May 17, 1921, P.L. 789, *as amended*, by the Act of December 14, 1977, P.L. 280, 40 P.S. § 221.15 (known as the Insurance Department Act of 1921). While numerous Appellants challenge the Plan on multiple and varying grounds, the threshold issue to be resolved is whether the Plan as submitted legally represents a legitimate plan of Rehabilitation or whether the Plan, in reality, is a de facto liquidation plan, filed by the Rehabilitator lacking any rehabilitative purpose, thus constituting an abuse of her discretion. Should this Court find that the proposed Plan represents a liquidation instead, the numerous appeals herein, which challenge specific provisions of the Plan of rehabilitation, would be rendered moot.

FACTS

The facts, as presented in the opinion of the Commonwealth Court, have been adopted and incorporated for our purposes herein.

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator of Mutual Fire, Section 515(a) of the Act, 40 P.S. § 221.15(a), and submitted a rehabilitation plan. Prior to this petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. § 221.10(d). At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders' surplus of nearly $161 million.

When it become apparent to the Commonwealth Court that adequate notice had not been given to policyholders and other creditors on whom the original plan would have a direct and substantial impact, hearing on the Plan's approval was continued generally. At the same time, the Court directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and creditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter, many objections were made. These objections were drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

In early 1987, upon application of several policyholders, also objectors to the plan, the Commonwealth Court formed a Committee of Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan." The Commonwealth Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia,* that the Rehabilitator had released no financial information or documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, the court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to the court's order approving the proposed plan, filed a report on the progress of the rehabilitation for the period from December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. The court granted the Rehabilitator's request for additional time and directed her to submit to the court a schedule of tasks to be performed in order to complete the evaluation. Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. § 221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and claims settlement services, Section 516(b) of the Act, 40 P.S. § 221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manager to oversee the rehabilitation on site.

On May 2, 1988, the Rehabilitator filed her report on the feasibility of implementing the amended plan approved June 26, 1987. After closing consultation, pursuant to Section 515(c) of the Act, 40 P.S. § 221.15(c), the court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S. § 221.16(a), and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.

On June 1, 1988, having reviewed the Rehabilitator's report on Plan implementation, which indicated the 1987 Plan was not feasible for several reasons, the court directed the Rehabilitator to submit a modified plan. The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate periodic payments of policyholders' claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to the Commonwealth Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's obligations to defend its insureds. The Rehabilitator also asked the court for a determination that Mutual Fire was insolvent.

The Rehabilitator submitted a new Plan of Rehabilitation on January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. The Commonwealth Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. The Commonwealth Court (Crumlish, P.J.) approved the Plan with certain modifications, and the instant appeal followed.

The Appellants in this matter are several insurance companies, policyholders and other creditors who have claims against Mutual Fire or other financial interests in the disposition of the company's assets. Specifically, the insurance companies are engaged in reinsurance or cedent[1] relationships with Mutual Fire, and the Committee of Policyholders, which has appeals at Nos. 20, 28 and 71, represents policyholders whose outstanding claims with Mutual Fire have yet to be paid.

SCOPE OF REVIEW

The General Assembly, in recognition of the specialized complexities involved in insurance generally, and in the regulation of this industry in particular, assigned the task of overseeing the management of that industry, in this Commonwealth, to the Insurance Department, the agency having expertise in that field. 40 P.S. § 41, *et seq.* The Insurance Commissioner, an appointed position pursuant to 40 P.S. § 42 is, therefore, afforded broad supervisory powers to regulate the insurance business in this Commonwealth, including the power to protect "the interests of insureds, creditors, and the public generally . . . ." 40 P.S. § 221.1(c). Accordingly, the delegation of such caretaking authority necessarily includes exercising a direct role in the rehabilitation of insolvent insurers. Subsection (c) of

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1. Cedents are those companies whom Mutual Fire reinsures. Plan of Rehabilitation, Section I(4).

Section 515 of the Insurance Act, 40 P.S. § 221.15, authorizes the Insurance Commissioner in her capacity as Rehabilitator "to take possession of the assets of the insurer . . . and to administer them under the order of the court."

Upon petition by the Commissioner to the Commonwealth Court for an Order authorizing him or her to rehabilitate an insurer pursuant to 40 P.S. § 221.15(a) and once such a rehabilitation plan has been ordered, the Rehabilitator is charged to "take such action as [s]he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer." 40 P.S. § 221.16(b). This mandate explicitly defers all actions to the skill of the Rehabilitator and implicitly recognizes her expertise in these matters. Additionally, the Rehabilitator is granted the power to retain those persons necessary to assist in the rehabilitation process. 40 P.S. § 221.16(a) ("Powers and Duties of the Rehabilitor").

Once the Insurance Commissioner and her deputies have designed a plan of rehabilitation it must be submitted to the Commonwealth Court for approval in order that it may have efficacy. The Commonwealth Court is empowered by the General Assembly to supervise and review the activities and proposals of the Insurance Commissioner while she undertake the rehabilitation of an insolvent insurer. 40 P.S. § 221.4(a); 42 P.S. § 761(a)(3). In overseeing the course of rehabilitation to check any abuse of discretion by the Commissioner, the Commonwealth Court is authorized to "approve or disapprove the plan [of rehabilitation] proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan." 40 P.S. § 221.16(d). Therefore, in order for the Plan to warrant the Commonwealth Court's imprimatur it must be found to be free from any abuse of the Rehabilitator's discretion.

Instantly, the Rehabilitator recommended a final, amended Plan of Rehabilitation to the Commonwealth Court on January 31, 1989. The group of policyholders designated to represent many creditors of Mutual Fire were notified of the specifics of the Plan and numerous objections were filed. After hearing several days of testimony and argument the Commonwealth Court approved the Plan with certain modifications by Order

dated January 23, 1990, and we now address those objections raised against the Plan.

As is evident from the above referenced statutory provisions, both the Insurance Commissioner and the Commonwealth Court are obligated to interact in order to supervise, implement and regulate equitably the process engaged to rehabilitate an insolvent or financially hazardous insurer. As a result of these specific assignments, it is not the function of the courts to reassess the determinations of fact and public policy made by the Rehabilitator. Rather, the involvement of the judicial process is limited to the safeguarding of the plan from any potential abuse of the Rehabilitator's discretion. In summarizing the law of this Commonwealth concerning judicial review of the determinations made by administrative agencies, we have stated:

> 'It has been established as an elementary principle of law that courts will not review the actions of governmental bodies or administrative tribunals involving acts of discretion *in the absence of bad faith, fraud, capricious action or abuse of power* . . . . That the court might have a different opinion or judgment in regard to the action of the agency is not a sufficient ground for interference; *judicial* discretion may not be substituted for *administrative* discretion.'

Norfolk & Western Railway Co. v. Pennsylvania Public Utility Comm. 489 Pa. 109, 128, 413 A.2d 1037, 1047 (1980) (quoting *Blumenschein v. Housing Authority,* 379 Pa. 566, 573, 109 A.2d 331, 334-35 (1954)) (emphasis added). This basic jurisprudential tenet was recently and emphatically reaffirmed by this Court in *Slawek v. Commonwealth, State Bd. of Medical Educ. and Licensure,* 526 Pa. 316, 586 A.2d 362 (1991).

It is axiomatic, therefore, that judicial discretion is not to be substituted for administrative discretion. We reaffirm *Norfolk* as the standard for determining whether or not the Insurance Commissioner abused her discretion in formulating the Plan of Rehabilitation. Upon application of the test, should the Commonwealth Court find such an abuse of discretion under the *Norfolk* standard, the Commonwealth Court is limited, by

statute, to preventing any further abuse of discretion by either rejecting the plan or modifying the plan and then approving it as modified. 40 P.S. § 221.16(d).

Ordinarily, this Court's review of the Commonwealth Court's actions would be consistent with the traditional appellate review of judicial discretion exercised in a judicial proceeding which is limited to determining questions of law and whether sufficient competent evidence exists to support the exercise of discretion engaged below, as enunciated in *Ben Avon Boro. v. Ohio Valley Water Co.*, 271 Pa. 346, 114 A. 369 (1921). However, instantly we are reviewing judicial discretion exercised in an area dedicated to the expertise of a given administrative agency, the guidelines for such review of which have been narrowly and specifically stated in *Norfolk, supra.* Therefore, upon review of the Commonwealth Court's discretion, our review must be equally specific and limited in order to remain consistent with the principles of Norfolk that restrict judicial discretion to those instances where the agency has abused its discretion.

Accordingly, in order to make a reasonable evaluation of the Commonwealth Court's review of administrative agency activity, in keeping with the principles of *Norfolk,* we adopt the following three part standard: (1) examination of whether the Commonwealth Court exceeded its statutory authority to approve, disapprove or modify the rehabilitation plan; (2) determine whether the Commonwealth Court substituted any of its own beliefs into the rehabilitation process; and (3) if so, whether the exercise of such discretion was for the prevention of further abuse by the Rehabilitator, and not to change the substance of the plan. Instantly, this limited scope of review is especially appropriate in a highly specialized industry such as insurance, where the skill, judgment and expertise of the Insurance Commissioner are statutorily recognized and deferred to, resulting in a broad scope of discretionary powers.

Numerous other jurisdictions in this country have also held that the decision of a Rehabilitator to rehabilitate the insolvent business of an insurer is within the sound discretion of the rehabilitator and should not be rejected by the reviewing court unless the Rehabilitator has abused that discretion. *Kueckelhan*

v. Federal Old Line Insurance Co., 74 Wash. 2d 304, 444 P.2d 667 (1968); *Carpenter v. Pacific Mutual Life Insurance Co.,* 10 Cal. 2d 307, 74 P.2d 761 (1937), *aff'd sub nom. Neblett v. Carpenter,* 305 U.S. 297 (1938).

In *Kueckelhan,* the applicable statute involved, Wash. Rev. Code § 48.31.040 (1989), has provisions very similar to the applicable Pennsylvania statutes.[2] There, the Rehabilitator is also directed to take possession of the assetts of the insurer and to conduct the business thereof with the goal of removing the causes and conditions which made the rehabilitation necessary. In discussing the role of the courts vis-a-vis the rehabilitative conduct of an Insurance Commissioner, the *Kueckelhan* court stated:

> The courts cannot dictate or outline the general policy or course of conduct of the Insurance Commissioner or his department . . . , because this outline is dependent on the terms of the applicable statutory provisions and not upon judicial discretion. Our statutory provisions, therefore, properly place the responsibility on both the Insurance Commissioner and the courts, the Commissioner being required to follow the statutory mandates and to use reasonable discretion in the rehabilitation of a seized company, *with abuses of discretion to be checked by the judiciary.*

Kueckelhan, 74 Wash. 2d at ____, 444 P.2d at 674 (emphasis added) (citations omitted). The Court in *Kueckelhan* added:

> "Toward this end [the Insurance Commissioner] must be afforded that freedom of action in the over-all management of the company which will permit him to knowledgeably evaluate, plan, devise, and implement a program which in his best judgment and in keeping with his expertise in the field of insurance will accomplish the objective of the proceeding."

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2. Due to these similarities between the applicable statute in *Kueckelhan* and the statutes governing insurance rehabilitation in this Commonwealth, we find the rationale of the Washington Supreme Court to be persuasive.

Id.

This Court has concluded that this great deference in favor of the Insurance Commissioner and the resulting narrow scope of review for the courts are in recognition of the expertise of the administrative agency or individual officer assigned the task of regulating a given industry. *See, e.g., Mathies Coal Co. v. Commonwealth, Department of Environmental Resources,* 522 Pa. 7, 599 A.2d 506 (1989); *Brocal Corporation v. Commonwealth, Department of Transportation,* 515 Pa. 224, 528 A.2d 114 (1987); *Pelton v. Commonwealth, Department of Public Welfare,* 514 Pa. 323, 523 A.2d 1104 (1987); *Pennsylvania Bankers Ass'n v. Secretary of Banking,* 481 Pa. 332, 392 A.2d 1319 (1978). Instantly, as the Plan *sub judice,* as modified, was a considered exercise of judgment on behalf of the Insurance Commissioner in her capacity as Rehabilitator and as it was thoroughly supervised and implemented with the capable assistance of the Commonwealth Court, as provided by statute, we cannot interfere with those findings or determinations made below, absent an abuse of discretion. Accordingly, for the reasons that follow, we believe the Plan of Rehabilitation, as modified by the Commonwealth Court, is a legitimate and proper exercise of the Rehabilitator's statutory powers, and properly effectuates the intentions of the rehabilitation statutes. We, therefore, with the exception of an additional modification to Section XVII of the Plan ("Interest") affirm the Order of the Commonwealth Court.[3]

REHABILITATION v. LIQUIDATION

Appellant Allstate challenges the Plan on the basis that it more properly represents a liquidation plan and as such, it has been improperly implemented under the Rehabilitation portion of the Insurance Act. It is argued that the instant plan does not contemplate a resuscitation of Mutual Fire's operations which is one of the stated purposes of the rehabilitation statute. Further,

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3. We restrict our review to only those issues properly raised before, and addressed by, the Commonwealth Court. Those issues not sought to be resolved which were not raised in the Commonwealth Court are deemed to have been waived. *See* Pa. R.A.P. 302(a).

opponents of the Plan claim it is in violation of *Neblett v. Carpenter* 305 U.S. 297 (1938), in which the United States Supreme Court held that a rehabilitation plan cannot impose harsher consequences than a liquidation. Under Neblett, creditors must fare at least as well under a rehabilitation plan as they would under a liquidation, which Appellants currently argue, would not be the case under this Plan. We disagree and affirm the finding of the Commonwealth Court that this plan properly effectuates the goals of rehabilitation embodied in 40 P.S. § 221.14 *et seq.*

The Commonwealth Court correctly concluded that the ultimate goal of the plan is to have Mutual Fire reemerge as a solvent insurer. The Plan calls for Mutual Fire's possible restructure and orders that it maintain its required capital and surplus minimums required in order to resume operations in the future.

The rehabilitation, in order to be legitimate, does not have to restore the company to its exact original condition. So long as the rehabilitation properly conserves and equitably administers "the assets of the involved corporation in the interest of investors, the public and others, (with) the main purpose being the public good" the plan of rehabilitation is appropriate. 2A *Couch on Insurance* 2d § 22.10. The Plan as it presently appears before this Court does provide the benefits of rehabilitation such as flexibility and the accelerated disposition of claims which the Commonwealth Court properly recognized as preferable to and distinct from, the ordinary procedures of liquidation. The Commonwealth Court after an extensive and thorough analysis concluded that the plan of rehabilitation best effectuates the "legislatively stated purpose (of) 'the protection of the interest of insureds, creditors and the public generally . . . .' and the 'equitable apportionment of any unavoidable loss' through inter alia, 'improved methods for rehabilitating insurers . . . .' Section 501 of the Act, 40 P.S. § 221.1." *Grode v. Mutual Fire, Marine and Inland Insurance Company,* 132 Pa. Commw. Ct. 196, 207, 572 A.2d 798, 803 (1990) (quoting 40 P.S. § 221.1(c)).

Finding no meritorious challenge to the Plan on this issue, and in recognition of the validity of the goals sought and the

scheme offered by the rehabilitation, we affirm the Commonwealth Court's holding that this is a legitimate plan of rehabilitation intended for the benefit of the public and not a *de facto* plan of liquidation.

In keeping with our limited and narrow scope of review we will now address *seriatim* the remaining issues raised before and resolved by the Commonwealth Court.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors to the plan assert that the Plan as proposed impermissibly impairs their various contractual rights. While this may in fact be an accurate assessment of the consequence of the proposed rehabilitation, such impairment is not a *per se* violation of law and we agree with the Commonwealth Court that any actual impairments are insubstantial.

Again, we must look to the broad powers afforded to the Commissioner granted in order to effectuate equitably the intent of the Rehabilitation statutes, i.e., to minimize the harm to *all* affected parties. As such, she has a fiduciary duty to marshall and preserve all assets of the insolvent entity. Furthermore, the exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that "individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public." *Vickodil v. Commonwealth, Insurance Department,* 126 Pa. Commw. Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989). *See also Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983).[4]

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4. Several Appellants, including the Member Companies of the Republic Group, 24 M.D. App. Dkt. 1990, allege that the setoff provisions impermissibly violate the impairment of contract provisions of both Art. I, § 10 of the United States Constitution and Art. I, § 17 of the Pennsylvania Constitution. In determining when state law may impair a contractual right, the *United States Supreme Court in Energy Reserves Group, Inc. v. Kansas Power and Light,* 459 U.S. 400 (1983), established a three-part test. The threshold inquiry is to determine whether the state statute in reality has operated to substantially impair a contractual relationship. *Id.* at 411. Should it be determined that a substantial impairment has occurred, the state must set forth a legitimate and significant public purpose. *Id.* at 412-13. Once that purpose is identified, the

Thus, the action of the Rehabilitator fosters the legitimate public purpose of safeguarding the public interest from the potentially innumerable consequences of Mutual Fire's insolvency. Accordingly, we find no error or abuse of discretion with this portion of the Plan as it is legitimately designed to amelio rate a financial hazard for the good of all involved. We, therefore, affirm this portion of the Order of the Commonwealth Court.[5]

SETOFF

Next, review of the Plan's setoff provisions requires a three-tiered analysis, as the provisions affect several groups of interested parties differently. Pursuant to the Insurance Act

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NOTES *(Continued)*

final inquiry concerns whether the adjustment of contractual rights is reasonable and of a nature appropriate to the public purpose justifying the legislation's adoption; however, if the state is not a contracting party, deference is given to the state's enunciated purpose. *Id.*

We agree with the Rehabilitator that the instant Plan satisfies this test. The Commonwealth Court properly upheld this portion of the Plan and concluded that in order to achieve the desired consequence of satisfying all claims in an equitable and orderly manner the resulting alleged contract impairments were insubstantial. Furthermore, the significant interest on behalf of the state to regulate the fiscal affairs of its insurers for the welfare of the public would still render the Plan permissible should impairment be found to exist. It is also worthy to note that the objectors to the Plan are members of a highly regulated industry and as such were well aware of the powers of a Rehabilitator. Accordingly, the Commonwealth Court properly dismissed Appellants' challenge to the setoff provision of the Plan under the federal constitution. As our impairment of contract provision, Art. I, § 17 of the Pennsylvania Constitution, mirrors that of the United States Constitution, we are guided by the United States Supreme Courts' analysis in *Energy Reserves v. Kansas Power & Light.* Therefore, we adopt the same test instantly and likewise dismiss the impairment of contract challenge made under the Pennsylvania Constitution.

5. The Commonwealth Court made minor adjustments, extractions and modifications to certain provisions of the Plan, including modifications later in the Plan concerning the allegation of contractual impairment discussed above. We will address these modifications later in the opinion at the appropriate time and place. It is to be noted, however, that most of the modifications to the Plan worked to mitigate certain objections of Appellants and as such they are appropriate.

"[M]utual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be set off and the balance only shall be allowed or paid . . . ." 40 P.S. § 221.32(a). This option was immediately challenged as this statutory provision allowing for setoff appears only under the liquidation portion of the Insurance Act, and thus it is argued cannot apply in support of the alleged plan of rehabilitation. As the Commonwealth Court correctly observed, this distinction "evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings." *Grode v. Mutual Fire, Marine & Inland Insurance Co.,* 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

However, should the plan of rehabilitation as proposed offer significant benefits in serving the public interest, the discretionary action of the Rehabilitator should be approved absent any arbitrary or manifest abuse of discretion. Furthermore, while Pennsylvania common law has long recognized and permitted the concept of setoffs, *Dickerson v. Dickersons Overseas Company,* 369 Pa. 244, 85 A.2d 102 (1952); *In re Kenin's Estate,* 346 Pa. 127, 29 A.2d 495 (1943), their application is not mandatory. Rather, the common law right to setoff, a form of contractual impairment, is an equitable right to be permitted solely within the sound discretion of the court. *In Re Bell,* 147 Pa. Super. 471, 24 A.2d 101 (1942); *Abrahams v. Wilson,* 134 Pa. Super. 297, 3 A.2d 1016 (1939); *Commonwealth ex rel. Sheppard v. Central Penn National Bank,* 31 Pa. Commw. Ct. 190, 375 A.2d 874 (1977).

The second point of contention is raised by Mutual Fire's reinsurers alleging that the Plan improperly includes a provision prohibiting any setoff of *premium obligations due Mutual Fire.* This argument is without merit and was properly rejected by the Commonwealth Court. Existing law, in plain words, expressly forbids a setoff of premium obligations. 40 P.S. § 221.32(b)(4) states in relevant part:

> (b) *No setoff* or counterclaim shall be *allowed* in favor of any person *where*:

> (4) *the obligation of the person is to pay premiums,* whether earned or unearned, to the insurer.

40 P.S. § 221.32(b)(4) (emphasis added). This *express* prohibition, however, appears only in the liquidation portion of the Insurance Act. Appellants argue that since the sole location of the premium setoff prohibition is in the liquidation section, this precludes its prohibition is in the liquidation section, this precludes its application in a rehabilitation context. However, they fail to recognize the fundamental language of 40 P.S. § 221.32(a). That section begins by stating that the setoff provisions *apply to any action or proceeding "under this article."* 40 P.S. § 221.32(a) (emphasis added). Since the term "this article" refers to Article V of the Act of May 17, 1921, P.L. 789, *as amended,* by the Act of Dec. 14, 1977, P.L. 280, 40 P.S. § 221.1 et seq. which encompasses both the sections on liquidation and rehabilitation, the relevant provisions regarding setoffs under the liquidation section must also apply to actions proceeding under the statutory rehabilitation provisions. Additionally, the provision of the Plan expressly prohibiting a premium setoff in a *rehabilitation* context, ensures that the creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding as mandated by the holding of *Neblett, supra.*

The goal of rehabilitation is to manage the affairs of an insolvent insurer with the intended result of restoring the entity to sound fiscal status. Instantly, it is essential that all assets flowing into the rehabilitated entity be treated preferentially in order that the insurer have an opportunity to remain afloat and survive. The statute involved implicitly recognizes this necessity to maintain and protect an insurers's principal asset, premiums due, from premature extinguishment. Therefore, the provision of the Plan denying premium setoffs is unquestionably valid and legitimately exercises the Rehabilitator's statutory powers, and thus, will properly remain undisturbed.

Next, various objectors to the Plan challenge the two definitions of setoff offered by the Plan. The first definition, referred to by some Appellants as the "basic setoff definition" or

"mandatory setoff definition", provides that: "[S]etoff for purposes of this Plan shall be calculated as of December 4, 1986.[6] Balances set forth on the books of Mutual Fire shall be conclusive." The only mutual debts and credits that may be setoff against one another are those "Due and owing[7] on December 31, 1986." *Plan of Rehabilitation* at 14. Objectors complain because this definition, limiting setoff to only those debts which are mutual, due and owing, prohibits the application of case reserves and incurred but not reported ("IBNR") claims.

The second definition under the Plan, referred to as the "optional setoff definition", provides:

> E. Election of Optional Setoff Definition
>
> 1. *Election.* A Reinsurer who is also a Cedent may pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan, in which event the Optional Setoff Definition set forth below shall apply to said Reinsurer. Balances set forth on the books of Mutual Fire shall be conclusive for this purpose.
>
> 2. *Optional Setoff Definition.* The Optional Setoff Definition shall be as follows:
>
> Any Reinsurer of Mutual Fire who is also a Cedent to Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to

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6. As originally submitted, this provision of the Plan had provided for a December 31, 1986 calculation date. This date was modified by President Judge Crumlish of the Commonwealth Court as part of his Order, modifying and approving the Plan as modified. This modification was ordered to preserve the fundamental right of the creditors to be treated, at a minimum, as well under the rehabilitation as they would in a liquidation.

7. The term "Due and Owing" is defined in Section I of the Plan as "Reinsurance recoverable on paid losses, paid Loss Adjustment Expenses, Claim Settlements and reimbursement agreements." Plan at 2.

Mutual Fire according to Mutual Fire's books pursuant to the following calculation:

Option Setoff Calculation[8] – The lesser of:

a. Mutual Fire's obligation to the Cedent for:

balances Due and Owing, plus reported Case Reserved, plus reported IBNR.[9]

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire for:

balances Due and Owing, plus Case Reserves. All as computed as of December 4, 1986.

The reinsurers again object, claiming the optional definition of setoff also fails to allow them to setoff their IBNR obligations to Mutual Fire that had not matured on the date of rehabilitation. Conversely, in support of the Plan's setoff provision and the modification made by the Commonwealth Court concerning the cut off date, the Insurance Commissioner argues: "[I]n so

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8. As President Judge Crumlish stated in his opinion concerning his modification of Section III, E.2.a of the Plan, pertaining to reinsurers who are also Cedents:

> ". . . [that Section] shall read so as to compute balance as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these objector's rights would be fixed as of that filing date. Section 520(d) of the Act, 40 P.S. § 221.20(d). Thus, this Plan modification assures that those objectors receive substantially the same set off rights and treatments they would receive in a liquidation."

Grode v. Mutual Fire, Marine and Inland Insurance Co., 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

9. These terms were defined by Appellee, Insurance Commissioner as follows:

> "Case reserves are estimates of amounts required to cover future payments on account of known claims. IBNR refers to amounts predicted to be paid in the future on account of events that have occurred but have not been reported as claims to the insurer.
>
> Appellees Brief at 58 fn. 8.

defining setoff, the Plan has given appropriate recognition to the traditional equitable remedy of setoff while limiting it to its appropriate scope by imposing the requirement that only matured, liquidated obligations may be setoff." Brief of Appellee at 57.

While the objections that the Plan effectively denies Appellants their right to setoff obligations to Mutual Fire that had not matured as of the time it went into rehabilitation is appealing on the surface, it bears repeating that it is a fundamental principle of Pennsylvania law that setoff is an equitable remedy and accordingly, is permissive, not mandatory. *In Re Bell, supra.* Furthermore, no right of setoff can be available against a note or other obligation that does not mature until after a receiver for the insolvent debtor is appointed. *Commonwealth ex rel. Bell v. Trademen's Trust Co.,* 250 Pa. 372, 95 A. 574 (1915). *Accord Appeal of Commonwealth Trust Co. of Pittsburgh,* 324 Pa. 161, 188 A. 200 (1936).

Instantly, we find this analysis especially compelling as case reserves are not present obligations of the reinsurer. Case reserves and IBNR are at most calculations or estimates of future potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation. Their speculative and intangible nature at the time of the petition of rehabilitation does not warrant their being available for setoff against more due and owing or mature obligations.

Assuming *arguendo,* however, that a case was established to support the applicability of case reserves and IBNR to setoff, this does not necessarily automatically create such an entitlement. Once again, it is fundamental that setoff is an equitable remedy within the sound discretion of the Rehabilitator and/or the trial court and absent an abuse of that discretion reviewing courts must refrain from involvement. In keeping with the stated intent of rehabilitation to protect and preserve the estate of the insolvent insurer for the benefit of all creditors, we find no error or abuse in denying the reinsurers the windfall which would result from allowing the reinsurer to offset obligations against Mutual Fire that had not matured as of the time the

petition for rehabilitation was filed. The setoff is being permitted, therefore, only to the extent that it encourages and facilitates the ultimate goal of rehabilitation. Accordingly, the setoff provision of the plan and the subsequent modification and approval of that provision by the Commonwealth Court shall also remain undisturbed.[10]

PRIORITY OF DISTRIBUTION[11]

Next, we examine the disposition rendered by the Commonwealth Court regarding the numerous challenges to the Plan's provision establishing the priority of distribution of claims to Mutual Fire's estate. Preliminarily, we dismiss the first challenge raised to, and addressed by, the Commonwealth Court concerning the Policyholders' objection to the Plan's June 30, 1991, cut-off date for recognition of loss claims. In order to foster the goals of rehabilitation, the Rehabilitator must be given the power to manage and control existing liabilities in order to reorganize and stabilize the financial structure of the insolvent insurer. We approve of the rationale engaged in by the Commonwealth Court when it opined:

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10. The Commonwealth Court is modifying, then approving the setoff provision of the Plan also struck down several additional portions of the provision. First, Section III, F., limiting the maximum allowable setoff of $25,000,000 was excised from the Plan as having no explicit or implicit statutory authorization in rehabilitation or liquidation proceedings. Secondly, the Plan's provision in Section II, G., proclaiming Mutual Fire's books and records to be conclusive was also deleted due to the established inaccuracy of those books. We uphold these changes by the Commonwealth Court, pursuant to its statutory power to modify the Plan as caretaker of the Plan, and to correct potentially arbitrary and unjust provisions resulting in a more equitable procedure for all involved.

11. The Plan establishes separate classes of claims for the purpose of the priority of distribution. They are as follows:

> Class 1 – Secured claims; Class 2 – Administrative claims of the Estate and Guarantee Associations; Class 3 – Wage claims; Class 4 – Policyholder claims; Class 5 – Surety Bond Lender claims; Class 6 – General Unsecured claims, including claims of cedents and reinsurers; Class 7 – Government claims; Class 8 – Late claims; Class 9 – Holders of Surplus and Contribution Notes; Class 10 – Owners, Officers and Directors.

> We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitator to submit a recommendation as to whether the date should be extended.

Grode v. Mutual Fire, Marine and Inland Insurance Company, 132 Pa. Commw. Ct. 196, 212, 572 A.2d 798, 806 (1990). While the consequence of this date designating a specific date beyond which the filing of loss claims is barred might work some hardships, the procedure is not inflexible and is both reasonable and necessary to manage effectively the rehabilitation of Mutual Fire for the ultimate benefit of all claimants to the estate.

The next challenge raised before and addressed by the Commonwealth Court concerns the objections of six of the ninety-one banks and financial institutions who, as surety bond lenders, allege they were improperly designated as a separate Class 5 in priority arguing that they were entitled to payment as Class 4 "policyholders." These objectors to the Plan (hereinafter "Lender Group") maintain that surety bonds are insurance policies entitling them to priority treatment under the Plan as Class 4 policyholders. They assert that because the issuance of surety bonds is regulated by the Insurance Department, the participants in Mutual Fire's bond program are entitled to the same priority of distribution under the Plan as Class 4 policyholders.

Initially, the Commonwealth Court recognized that there exist fundamental differences between bilateral contracts of insurance and tripartite surety bond agreements. It concluded

that the differences between their respective premium calculations, payments, and terms and conditions of cancellation and renewal, support "the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance." *Id.* at 213, 572 A.2d at 806.

The Commonwealth Court also rejected the previously made assertion that the fact that surety bond issuances are regulated by the Insurance Department is dispositive. Rather, the court adopted the view taken by the United States Supreme Court in *Pearlman v. Reliance Insurance Co.,* 371 U.S. 132, 140 n. 19 (1962), wherein it stated: "Among the problems which would be raised by a contrary result would be the unsettling of the usual view, grounded in commercial practice, that suretyship is not insurance." *See* Cushman, *Surety Bonds on Public and Private Construction Projects,* 46 A.B.A. J. 649, 652-653 (1960). The Commonwealth Court correctly conclude:

> Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those of policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

Grode, at 214, 572 A.2d at 806. We find no error in the rationale and determinations employed by the Commonwealth Court regarding this issue. Thus, the Commonwealth Court's approval of the Plan's creation of a separate Class 5 subordinating the surety bond lenders claims to those of the Class 4 policyholders was appropriate.

The Plan's established priority of distribution has been further assailed by the Lender Group which objects to the creation of a Class 6 fund. Specifically, Section II, F.6.1. provides the following:

> 1. Creation of Class 6 fund. On or before the Effective date, a segregated account (the "Class 6 Fund") shall be established by the Rehabilitator. The

> Class 6 Fund shall be funded by depositing in the Class 6 Fund, from time to time, twenty-five percent (25%) of all reinsurance collected by Mutual Fire, with respect to the assumed reinsurance business of Mutual Fire. All interest earned shall be transferred to the general account of the Rehabilitator and used by the Rehabilitator as a general unliened asset of the estate of Mutual Fire.

Plan at 17.

As the court properly noted in explaining why no abuse of discretion existed on the part of the Rehabilitator in creating separate Classes 5 and 6:

> [T]hese Class 5 lenders, who fall immediately behind the Class 4 policyholder but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the plan. Since under the Act the lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class 6 segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett*.

Id. at 214, 572 A.2d at 807.

The objectors to this provision maintain that as Class 5 lenders, the creation of the fund inequitably demotes them to a sub-class of creditors subordinate to the Class 6 of general unsecured creditors. Because the Insurance Act prohibits the Lenders Group from attaining a higher distribution priority than general unsecured creditors, the Commonwealth Court held that the establishment of a Class 5 and the funding of a separate Class 6 account were provisions well within the Rehabilitator's broad discretion. Accordingly, the Court stated:

> In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those

> statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute that the consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in this proceeding.

Grode at 215, 572 A.2d at 807.

While perfection may be an unattainable characteristic of the Plan, this does not provide us with legitimate grounds for disturbing the more expert approval of provisions which are manifestly reasonable. So long as the provisions of the Plan strike a fair and proper balance between the competing secured and unsecured creditors the Plan must survive the objections raised to it.

UNITED STATES CLAIMS

The United States government also raises an objection to the Plan, complaining of the Class 7 status to which their claims were assigned. They object, citing 31 U.S.C. § 3713 (1983), known as the Federal Priority Act which in relevant part requires that:

> (a)(1) A claim of the United States *shall be paid first when* -
>
> A) a person indebted to the government *is insolvent* . . .

31 U.S.C. § 3713(a)(1)(A) (emphasis added).

The Rehabilitator responds to this objection by arguing that the McCarran-Ferguson Act prohibits any federal statute from impairing or invalidating any state insurance regulation. 15 U.S.C. § 1012. The Act states in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede

any law enacted by any state for the purpose of regulating the business of insurance . . . ." 15 U.S.C. § 1012(b). We refrain from deciding the question concerning the applicability of the McCarran-Ferguson Act as did the Commonwealth Court. Suffice it to say, however, that we quote with approval both the factual determination made below and the resulting remedy temporarily ordered by the Commonwealth Court:

> Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United States Government claims. We further direct her to report to this Court the amount contained in this set-aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.
>
> First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation ("FSLIC") receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against *insureds* of Mutual Fire; and (3) claims made by Westinghouse Electric Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

Grode, at 216, 572 A.2d 798, 808 (emphasis in original).[12]

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12. We are aware of decisions from other jurisdictions which do not recognize the McCarran-Ferguson Act as barring the federal government from obtaining first priority status in insolvency proceedings. Matter of Union Indemnity Ins. Co. of New York, 551 N.Y.S.2.d 446, 146 Misc.2d 558 (1990)

JUDGMENT CREDITORS

Pepsi-Cola Bottling Company of Charlotte, North Carolina, Inc. (hereinafter "Pepsi"), appeals from the Commonwealth Court's approval of the plan, alleging that as a federal court judgment holder against Mutual Fire, the principle of the Full Faith and Credit Clause of the United States Constitution mandates that it be given full payment, including interest, due to an alleged superiority of its claim, irrespective of the insurance rehabilitation proceedings.

Initially, the contention by Pepsi that it is entitled to an elevated priority by virtue of its status as a federal court judgment holder is both unsubstantiated and without merit. This theory is unsupported by existing case law and neither the provisions of 40 P.S. § 221.14 *et seq.* providing for rehabilitation, nor 40 P.S. § 221.19 *et seq.* providing for liquidation, contemplate a specific elevated priority for judgment creditors. As the Commonwealth Court stated in refuting this contention: "On the contrary, the serving of a judgment does not elevate the status of such claims." *Grode* at 217, 572 A.2d 798, 808 (*citing Davis v. Commonwealth Trust Co.,* 335 Pa. 387, 7 A.2d 3 (1939)).

NOTES *(Continued)*

(IRS unaffected by McCarran-Ferguson Act's regulation or insurance business). Instantly, the primary federal presence regarding claims against Mutual Fire concerns claims made by the Federal Deposit Insurance Corporation ("FDIC") and the Federal Savings and Loan Insurance Corporation ("FSLIC"). However, as the FDIC has been held not to be an integral part of the government scheme, FDIC claims have not been held to be a claim of the United States Government," 31 U.S.C. § 3713, which would therefore be entitled to priority. Lapadula V. Villani, Inc. v. United States, 563 F. Supp. 782 (S.D.N.Y. 1983). The FSLIC, has been held, in terms of its function, as identical to FDIC. *See* In Re Federal Savings and Loan Insurance Corporation, 837 F.2d 432, 434 (11th Cir. 1988); Federal Savings and Loan Insurance Corporation v. Quinn, 419 F.2d 1014, 1017 (7th Cir. 1969); Federal Savings and Loan Insurance Corporation v. Williams, 599 F. Supp. 1184, 1204 (D. Md. 1984). As the regulation of insurance companies both solvent and insolvent has been conceded to the states and since the goal of 15 U.S.C. § 1012 was to exempt insurance activities from federal antitrust laws to preserve the state regulation of insurance companies, it would appear that the McCarran-Ferguson Act operates to preclude the applicability of the Federal Priority Act.

While Pepsi may not be expressly entitled to an elevated priority for purposes of Class 4 distribution, another facet of the Plan's treatment of Pepsi warrants our discussion. Pepsi alleges that its judgment, including interest, against Mutual Fire was filed on September 4, 1986, one week before the Insurance Commissioner suspended the business of Mutual Fire and three months before the Commissioner filed the Petition for Rehabilitation. In approving the Plan, however, the Commonwealth Court recognized that the judgment in favor of Pepsi against Mutual Fire "is binding on and cannot be altered by the Rehabilitator." *Grode* at 217, 572 A.2d 798, 808. The problem concerns Section XVII of the Plan which expressly prohibits the payment of interest to creditors unless provided for in the Plan. Thus, an apparent inconsistency exists which resulted in Pepsi filing a Motion For Clarification of the Commonwealth Court's Order approving the Plan, a motion which appears to remain without a ruling.

The case relied upon by both parties, *Davis v. Commonwealth Trust Co.,* 335 Pa. 387, 7 A.2d 3 (1939), while proper authority to deny Pepsi's earlier claim of elevated priority, is not analogous for purposes of the instant dilemma concerning the viability of interest awarded. In *Davis,* the issue concerned the claim of a creditor which had been awarded a judgment against the liquidating trustee by a court *years after the liquidation started.* Pepsi's judgment entered September 4, 1986 provides:

> NOW, THEREFORE, IT IS ORDERED, ADJUDGED AND DECREED that on its first claim for relief, denominated First Count in the complaint, plaintiff Pepsi-Cola Bottling Company of Charlotte, Inc. have and recover of and from defendant The Mutual Fire, Marine and Inland Insurance Company the principal sum of One Million Two Hundred Dollars ($1,200,000.00), plus interest thereon at the legal rate, eight percent (8%) per annum, from and after the date of the breach, May 21, 1986, plus costs.

The Court noted that this judgment is binding, inviolate and not subject to any alteration by the Rehabilitator. We view that statement as an implied modification of the Plan's interest

prohibition contained in Section XVII as respects Pepsi-Cola Company of Charlotte, Inc. While the Rehabilitator's equitable powers do afford her the authority to limit or deny interest which accrues *after a petition for rehabilitation or liquidation has* been filed, the federal judgment held by Pepsi including the amount for interest expressly provided for from May 21, 1986 must be accepted and given dignity up until December 4, 1986, the date the Insurance Commissioner sought to invoke her equitable powers pursuant to her Petition for Rehabilitation.[13]

Accordingly, we remand this issue to the Commonwealth Court for the purpose of modifying its January 23, 1990 Order, in favor of maintaining Pepsi-Cola Bottling Company of Charlotte, Inc. as a Class 4 policyholder creditor, for the full amount of the federal judgment entered on September 4, 1986, including all interest provided for between May 21,1986 and December 4, 1986.

LOSS ADJUSTMENT EXPENSES

Numerous claimants have objected to the Plan complaining about the provision contained therein which provides for equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989. These expenses are extensive, resulting from the necessity to retain a competent staff to manage and oversee the rehabilitation, a staff of claim adjusters, claim investigators and legal counsel. While many retainer arrangements were well intended, they were entered into prior

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13. This result, we believe, properly satisfies the results of applicable case law. Under the Full Faith and Credit Clause, Article Four, Section One of the United States Constitution, and an implementing statute, 28 U.S.C. Section 1738, Pepsi's federal court judgment is to be accepted by the states as conclusive proof of the rights adjudicated. *See Stroll v. Gottlieb,* 305 U.S. 165, *reh'g denied,* 305 U.S. 675 (1938). The result of disallowing the payment of interest of Pepsi's judgment for any period beyond the date the Petition of Rehabilitation was filed, is also consistent with those decisions wherein courts have held that interest accruing on claims after insolvency proceedings have begun is payable only after the principal on all claims have been paid in full. *American Iron and Steel Manufacturing Co. v. Seaboard Airline Railway,* 233 U.S. 261, 266 (1914); *Commw. ex rel. Woodside v. Seaboard Mutual Casulty Co.,* 420 Pa. 237, 215 A.2d 673 (1966).

to the insolvency. Now, presented with a dire need to economize in order to survive, the Rehabilitator must lead the process, free to eliminate or reduce many of the self-serving interests involved. While the effect of the Plan may cause economic suffering to some private contracting parties, we remain mindful that when an insurance company becomes insolvent, individual interests might have to be sacrificed or compromised in order to preserve the ultimate goal of this process, the overall good of the general public and the insurer's policyholders. *Vickodil v. Commonwealth Insurance Department,* 126 Pa. Commw. Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989).

Accordingly, we find no error on behalf of the Commonwealth Court's modifying and approving the following portions of the loss adjustment expenses provision of the Plan. First, it is unquestionably reasonable to make modifications to the Plan which instill in it greater flexibility, mitigate some of the harsher consequences and emphasize a process of scrutiny which will guarantee a regular review of costs and expenses and a general system of accountability to the Court. We, therefore, adopt with approval the following language employed by the Commonwealth Court:

> Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.
>
> At the same time, we will further Order the Rehabilitator to review *all* employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth

> repeating, that each dollar expended in administrative and unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be undertaken forthwith.

Grode at 218-19, 572 A.2d 798, 809 (emphasis in original).

PROPORTIONAL PAYMENTS METHOD

Section VI of the Plan allows for interim partial payments made periodically on Class 4 Adjusted Claims (Policyholder Loss Claims and Guaranty Association Loss Claims) of $5,000.00 or less per Adjusted Claim as cash is available. After a thorough review of this provision, the Commonwealth Court approved the Plan with the following modifications: first, payments were required to be made pursuant to this provision by June 1, 1990 according to a payment schedule and schedule of distribution dates submitted for the Court's approval; second, the Court modified the Plan "so that payments of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program." *Grode* at 219, 572 A.2d at 809. The Commonwealth Court agreed with the Policyholders Committee that "this latter modification will minimize the preference otherwise given to policyholders with multiple claims." *Id.*

The small payment provision will accelerate the disposition of numerous claims which would otherwise develop into greater expense to the estate. The payment of small claims whether adjusted or not by the date of the order approving the plan is likewise, legitimate and reasonable. As the Commonwealth Court properly reasoned, a distinction between adjusted claims or unadjusted claims which limited payment under this provision solely to unadjusted claims, "would punish these claimants who have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings." *Id.*

MISCELLANEOUS PROVISIONS

With regard to the Commonwealth Court's disposition of the jurisdictional issue, 40 P.S. § 221.4, we are in complete agreement. Article V of the Insurance Act simply and plainly recognizes the Commonwealth Court's exclusive jurisdiction over delinquency proceedings. 40 P.S. § 221.4(d) ("All actions . . . shall be brought in the Commonwealth Court in the Commonwealth of Pennsylvania"). Accordingly, it was appropriate for the Court to strike Sections VIII (c) and (e) as being inconsistent with the provisions of that Article. Conversely, it was also proper for the Court to approve Sections (a), (b), (d), (f) and (g) as they were viewed to correctly invoke the exclusive jurisdiction of the Commonwealth Court over matters concerning the interpretation of the Plan and the rehabilitation itself pursuant to 40 P.S. § 221.4. Additionally, Section X.A, concerning dispute resolution of claims other than those subject to arbitration, was likewise approved below. The court's interpretation that the provision permits parties to a dispute to *request* the Commonwealth Court's intervention and resolution in lieu of arbitration is correct. We find no grounds for our intervention here.

DISSOLUTION OF THE POLICYHOLDERS COMMITTEE

Next, a large controversy surrounds the Plan's proposal to dissolve the Policyholders Committee appointed January 28, 1987 by the Court. The Commonwealth Court dissolved the Committee by Order of November 22, 1989.

The Policyholder Committee complains that not only is the Policyholder Class entitled to continued representation but that continued separate representation of the Class is necessary for adequate representation of the interests of Mutual Fire policyholders. Thus, they allege that the Commonwealth Court erred in dissolving the Committee. The Rehabilitator responds claiming that the real issue is not whether the Commonwealth Court acted improperly but whether she abused her discretion by determining that the Committee's fees and expenses should no longer be paid out of the estate of Mutual Fire after November 22, 1989. The Commonwealth Court, after thorough review of

the competing positions, rejected the objection to the dissolution and concluded that those considerations of fairness which compelled the creation of the Policyholder Committee no longer existed in view of the outrageous cost its continued presence would have on Mutual Fire's diminished estate. We agree.

The Commonwealth Court concluded, that by virtue of the instant plan and especially due to the "hardship" and "proportional payment" provisions contained therein, those parties in particular need of protection, i.e., the small policyholders, now have their interests represented and protected. *Grode,* 132 Pa. Commw. at 222, 572 A.2d at 811. This unquestionably satisfies the statutorily charged duty of the Rehabilitator to protect the interests of Mutual Fire insureds. Likewise, we adopt the rationale of the Commonwealth Court in approving its rejection of the Committee's claim that dissolution leaves the policyholders unrepresented. As President Judge Crumlish reasoned:

> As we have stated, the Rehabilitator is statutorily charged with that duty. Moreover, dissolution of the Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's aegis, as have the other creditors' groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Id.[14]

We next consider the Commonwealth Court's elimination of Section XIII B, the immunity provision contained in the Plan, on the basis that it was unjustified and supererogatory since no

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14. The Plan, once approved should be structured to equitably address all eventualities, conflicts and concerns. As we view the Plan to most efficiently and equitably do so, the role of the Policyholder Committee as representative of policyholder interests is no longer necessary. Indeed, in view of the testimony offered regarding the Committee's numerous attempts to interfere with the Plan, ignore Orders of the Court and bill the estate of Mutual Fire millions of dollars in expenses and fees, its continued presence may be an unacceptable financial detriment.

such provision in the Plan "may confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Section 8501-8528 and 8541-8564 of the Judicial Code, 42 Pa. C.S. §§ 8501-8528, 8541-8564." *Grode* at 222-23, 572 A.2d at 811. Sections 8521 *et seq.* of the Judicial Code, 42 Pa. C.S. § 8501-8528 dealing with Sovereign Immunity, expressly enumerate the limited exceptions to the general prohibition against holding a Commonwealth Agency and any of its employees liable with respect to acts within the scope of their office or agency. The Rehabilitator and her deputies as agents of the Commonwealth are controlled by these provisions and its limitations. Accordingly, the Commonwealth Court reasonably eliminated the immunity provision as unnecessary and inconsistent with the controlling, applicable statutes regarding Sovereign Immunity.

Finally, we address the Plan's indemnification agreement and the Commonwealth Court's approval of this provision. First, the Policyholders Committee argues that certain employment agreements entered into by the Rehabilitator ought to be disapproved. Specifically, they seek to eliminate the employment of more than one deputy and strike those portions of the agreements with the appointed deputies and other employees which contain indemnification agreements. We agree with the Commonwealth Court, who in rejecting this contention stated that pursuant to 40 P.S. § 221.16(a) and (b) the Rehabilitator is given

> express power to "appoint a special deputy who shall have all the powers of the Rehabilitator" and who shall "serve at the pleasure of the Commissioner." In addition, the Rehabilitator "shall have full power to direct and manage, to hire and discharge employes . . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

Grode at 223, 572 A.2d at 811. We find no fault with this rationale or conclusion.

The Policyholders Committee also argues that indemnification agreements between the Rehabilitator and her deputies are necessarily void as against public policy, relying upon *Dilks v. Flohr Chevrolet, Inc.*, 411 Pa. 425, 192 A.2d 682 (1963), and *In re Hodgson's Estate,* 342 Pa. 250, 20 A.2d 294 (1941). First, despite these objections, the Commonwealth Court upheld the indemnity provisions and their legitimacy, distinguishing the present matter from *Hodgson's Estate, supra,* in which the rule applied in the context of testamentary trust litigation. The court held that the rehabilitation deputies do not act in the same fashion as executors or administrators in a probate context. The court then rejected the Policyholders Committees' reliance upon *Dilks supra,* which it held did not "stand for the proposition that exculpatory clauses, which may be voided as against policy, *Boyd v. Smith,* 372 Pa. 306, 94 A.2d 44 (1953), and *indemnity* provisions receive the same treatment under Pennsylvania law." Grode at 224, 572 A.2d at 812 (emphasis in original). Rather, the Commonwealth Court found persuasive and relied upon the reasoning of the United States Court of Appeals for the Third Circuit in *Jamison v. Ellwood Consolidated Water Co.*, 420 F.2d 787, 789 (3d Cir. 1970), to reach its conclusion that the public policy concerns regarding exculpatory clauses were not determinative of the legality of indemnity agreements. Furthermore, the court identified some valid policy concerns in support of its rejection of the Policyholders Committees' arguments and in upholding the appropriateness of the indemnity agreement, stating:

> In order to attract persons of proven ability, that necessity dictates that those persons be somehow insulated from the fears and costs of possible litigation by naturally disgruntled claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties.

Grode, at 225, 572 A.2d at 812.

While the Plan as modified and approved by the Commonwealth Court and as modified by this Opinion may adversely

affect some individual interests, we believe that it legitimately seeks to equitably apportion unavoidable losses and is free from arbitrary or capricious provisions which would render the Plan unacceptable as an abuse of the Rehabilitator's discretion.

Accordingly, after a thorough review of the objections presented and the various components of the Plan, we remand Section XVII of the Plan to the Commonwealth Court to modify that provision consistent with this Opinion. We approve the remaining provisions of the Plan as modified by the Commonwealth Court. Affirmed in part, remanded in part.

Mr. Justice Larsen and Mr. Justice McDermott did not participate in the consideration or decision of this case.

DATED: August 21, 1992

JUDGEMENT ENTERED:

(Mildred E. Williamson)
DEPUTY PROTHONOTARY

APPENDIX B

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA, PLAINTIFF

v.

THE MUTUAL FIRE MARINE AND INLAND INSURANCE COMPANY, DEFENDANT

572 A.2d 798 (Pa.Cmwlth. 1990)
Crumlish, Jr., President Judge

OPINION

Constance Foster, Commonwealth Insurance Commissioner, as statutory Rehabilitator (Rehabilitator), has petitioned this Court for approval of her modified Plan of Rehabilitation (Plan) for The Mutual Fire, Marine and Inland Insurance Company (Mutual Fire), a mutual casualty insurance company created and chartered under the laws of Pennsylvania. Commissioner Foster seeks this Court's approval pursuant to Section 516(d) of Article V of the Act of May 17, 1921, P.L. 789, *as amended,* added by the Act of December 14, 1977, P.L. 280, 40 P.S. § 221.16(d) (known as The Insurance Company Law of 1921 (Act)). We modify the Plan in part and hereby approve it.

Before proceeding with disposition of the Plan and the various objections thereto, we briefly summarize the events leading to this decision.

Mutual Fire, founded in 1902, was primarily a property and casualty insurance carrier for most of its history. In the late 1970's, Mutual Fire, along with others in the industry, became more heavily entrenched in reinsurance arrangements with other carriers. Generally speaking, under these arrangements, Mutual Fire ceded a portion of its business to other insurers who agreed to protect Mutual Fire from the risks it undertook. Conversely, Mutual Fire assumed business from other insurers under the same or similar agreements. By the mid-1980's, between 60% and 70% of Mutual Fire's business entailed reinsurance, involving over 8,000 agreements or "treaties" worldwide. At approximately that time, Mutual Fire also wrote a large number of surety bonds as part of financing packages for

oil, gas and real estate limited partnerships. In addition, Mutual Fire's "direct book" liability coverage began to show diminishing profitability.

We need not dwell too long, however, on the causes of Mutual Fire's financial straits for purposes of this determination. Suffice it to say that at year-end 1988, immediately before the present Plan was proposed, Mutual Fire's deficit was over $400 million, constituting the country's fourth largest insurer insolvency.[1]

THE 1987 PLAN OF REHABILITATION

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator of Mutual Fire, Section 515(a) of the Act, 40 P.S. § 221.15(a), and submitted a rehabilitation plan. Prior to his petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. § 221.10(d).[2] At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders surplus of nearly $161 million.[3]

When it became apparent to this Court that adequate notice had not been given to policyholders and other creditors on whom the original plan would have a direct and substantial impact, hearing on its approval was continued generally. At the same time, we directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and creditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter, many objections were made. These objections were

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1. McLeod, "New Mutual Fire Rehabilitation Plan Proposed," *Business Insurance*, March 6, 1989, at 3.

2. The supervision order was entered September 13, 1986. Such orders enjoin the insurer from disposing, conveying or encumbering assets; withdrawing bank accounts; lending or investing funds; transferring properties; incurring debts or other obligations or entering any new reinsurance contracts without prior approval. 40 P.S. § 221.10(d).

3. Annual Statement 1986, Exhibit No. 7, 7/26/89.

drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

In early 1987, upon application of several policyholders, also objectors to the plan, this Court formed a Committee of Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan."[4] This Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.[5]

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia*, that the Rehabilitator had released no financial information or documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, this Court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those

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4. Order of January 28, 1987.

5. The liquidation provisions of Article V elevate the "claims under policies for losses wherever incurred, including third party claims, against the insurer for liability for bodily injury or for injury to or destruction of tangible property which are not under policies . . .," Section 544(c) of the Act, 40 P.S. § 221.44(c), to the highest priority of distribution after wage claims, 40 P.S. § 221.44(a), and administrative expenses 40 P.S. § 221.44(b). Although there is no Pennsylvania authority directly on point, we agree with decisions in other jurisdictions construing similar insurance insolvency statutes that the equitable purpose of rehabilitation and liquidation is to protect *first of all* consumers of insurance. *See, e.g., State ex rel. Long v. Beacon Insurance Co., 87 N.C.App. 72, 359 S.E.2d 508 (1987).*

stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to this Court's Order approving the proposed plan, filed a report on the progress of the rehabilitation for the period December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. We granted the Rehabilitator's request for additional time and directed here to submit to the Court a schedule of tasks to be performed in order to complete the evaluation.[6] Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. § 221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and claims settlement services, Section 516(b) of the Act, 40 P.S. § 221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manager to oversee the rehabilitation on site.

On May 2, 1988, the Rehabilitator filed her report on the feasibility of implementing the amended plan approved June 26, 1987. After close consultation, pursuant to Section 515(c) of the Act, 40 P.S. § 221.15(c), this Court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S. § 221.16(a), and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.[7]

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6. Order of October 27, 1987.

7. Since that time, the Rehabilitator has by writ of summons or complaint instituted legal action against, *inter alia,* Peat, Marwick, Main & Co., seeking damages of in excess of $350 million; GET Reinsurance Limited, seeking damages in excess of $13 million; the Berwind Corporation for 18 U.S.C. § 1962 ("RICO") violations, fraud and other causes of action. The Rehabilitator has also brought suit against Chesapeake Insurance Company, Ltd.; and

On June 1, 1988, having reviewed the Rehabilitator's report on plan implementation, which indicated the 1987 plan was not feasible for several reasons, we directed the Rehabilitator to submit a modified plan.[8] The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate periodic payments to policyholder claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to this Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's obligations to defend its insureds. The Rehabilitator also asked this Court for a determination that Mutual Fire was insolvent.[9]

The Rehabilitator submitted a new Plan of Rehabilitation January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. This Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. It is this Plan and the objections filed thereto which we now address.

REHABILITATION v. LIQUIDATION

[1] Objections to the Plan were raised on the grounds that it is, in name only a rehabilitation and is in effect a

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Keswick & Curran, Incorporated. Additional litigation will be commenced when it is determined to be in the best interest of the estate.

8. Order of June 1, 1988. In her feasibility report, the Commissioner indicated, *inter alia*, that reserves on a portion of Mutual Fire's direct book were substantially in excess of estimates assumed in the 1987 plan; that collection of reinsurance recoverables would require resort to protracted litigation; and that an assumed favorable resolution of Mutual Fire – "Resolute Re" arbitration had not at that time occurred.

9. On February 9, 1989, this Court, after examining Mutual Fire's records, determined it to be insolvent as that term is defined in Section 503 of the Act, 40 P.S. § 221.3. We expressly declined to make a finding as to when Mutual Fire became insolvent. This determination of insolvency triggered guaranty fund association coverage.

liquidation. The objectors argue, therefore, that the Rehabilitator should be ordered to liquidate Mutual Fire. Several objectors maintain that it is anomalous to rehabilitate an insurance company that has been determined insolvent. We are not persuaded by their arguments, however.

Initially, we recognize that insolvency is one of several expressly enumerated grounds on which an order of rehabilitation may be based. Section 514(l) of the Act, 40 P.S. § 221.14(l). Thus, the statute admits of circumstances in which insolvent insurers are to be rehabilitated. *See, e.g. Insurance Department v. Safeguard Mutual Insurance Co.*, 18 Pa. Commonwealth Ct. 195, 336 A.2d 674 (1975), aff'd as modified, 478 Pa. 592, 387 A.2d 647 (1978).

The statute authorizes the *Commissioner to petition the Commonwealth Court* for liquidation, Section 517 of the Act, 40 P.S. § 221.17, and an order to liquidate requires notice and hearing. Section 520 of the Act, 40 P.S. § 221.20. The Rehabilitation has not put forth such a petition.

Moreover, we agree with the Rehabilitator and, at least one objector to the Plan, that the benefits of rehabilitation – its flexibility and avoidance of inherent delays – are preferable to the static and cumbersome procedures of statutory liquidation. The statute's purpose is, in the end, that to which we must give effect. That legislatively stated purpose is "the protection of the interests of insureds, creditors, and the public generally . . . ." and the "equitable apportionment of any unavoidable loss" through, *inter alia,* "improved methods for rehabilitating insurers. . . ." Section 501 of the Act, 40 P.S. § 221.1. No interest is served by adding to the delay which has already occurred in this case. On the contrary, the goals of Article V of the Act are better served by a rehabilitation which effectively ensures more distribution in a shorter period of time than would occur in liquidation. *See Neblett v. Carpenter,* 305 U.S. 297, 59 S.Ct. 170, 83 L.Ed. 182 (1938).[10]

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10. Objectors rely in *Neblett* for the proposition that the Rehabilitator cannot fashion a Plan which does not give a party in rehabilitation the same or greater rights than he would have in liquidation. The effect of this principle on the Rehabilitator's proposed Plan will be discussed later in this opinion.

Notwithstanding those objectors' protestations that this is a *de facto* liquidation, we find nothing in the statute precluding the Rehabilitator from pursuing this rehabilitation as an improved method for rehabilitating insurers, particularly where the record indicates that affected persons, including the objecting creditors, would *at least in terms of amounts* recovered, fare better under this rehabilitation than in statutory liquidation. Rehabilitator's Exhibits Nos. 5 and 6, 7/25/89.

The Plan itself calls for Mutual Fire's possible corporate restructure, and Mutual Fire will maintain its required capital and surplus minimums. The record also indicates that rehabilitation will preserve the value of Mutual Fire's insurance charters and perhaps the even greater value of operating losses. Notes to Testimony (N.T.), 7/25/89, pp. 88-90. This Court is aware of at least two instances where potential buyers have approached the Rehabilitator's deputy. N.T., 7/25/89, pp. 151-152. Of course, no one disputes that the rehabilitation as proposed contemplates the windup of Mutual Fire's current business, but it is not altogether accurate to say that the Rehabilitator intends no rehabilitative purpose. It must be remembered that Mutual Fire's assets, liabilities and operations were of a far smaller order of magnitude prior to the expansion of the reinsurance and surety bond business in the late 1970's and early 1980's.

This Court has held that the Act itself evidences the General Assembly's intent to treat rehabilitations and liquidations as separate, distinct proceedings. *Muir v. Transportation Mutual Insurance Co.*, 105 Pa. Commonwealth Ct. 156, 523 A.2d 1190 (1987). The differences between the rehabilitation and liquidation provisions are readily apparent. The liquidation provision fixes the rights and liabilities of the insurer and its creditors as of a date certain, Section 521 of the Act, 40 P.S. § 221.21; the rehabilitation statute is silent on this matter. The liquidation provision establishes an order of distribution, Section 544 of the Act, 40 P.S. § 221.44; the Act's rehabilitation section does not. Significantly, the liquidation provision expressly allows for setoffs, Section 532 of the Act, 40 P.S. § 221.32; no such mention is made in that part of the statute governing rehabilitations.

[2] The lack of express direction governing rehabilitations where it is otherwise given in liquidation proceedings compels the conclusion that the Insurance Commissioner, as Rehabilitator, is given broader discretion to structure a rehabilitation plan than is given to her as statutory liquidator. *Id.* In limiting this discretion, the General Assembly has given this Court, by virtue of the Judicial Code, 42 Pa.C.S. § 761(a)(3), and Section 504(a) of the Act, 40 P.S. § 221.4(a), the jurisdiction and authority to oversee rehabilitation proceedings in this Commonwealth. The Court may "approve . . . disapprove . . . or modify" a plan proposed to it. 40 P.S. § 221.16(a). We are aware, however, of the well-settled principle that judicial discretion may not be substituted for administrative discretion. *Blumenschein v. Housing Authority of Pittsburgh,* 379 Pa. 566, 109 A.2d 331, (1954), *appeal dismissed,* 350 U.S. 806, 76 S.Ct. 68, 100 L.Ed. 724 (1955).

[3] Thus, we perceive that the Rehabilitator's broad powers in these proceedings are circumscribed by this Court's mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss. Of course, the Rehabilitator is constrained by constitutional mandate.

As has been noted, many objectors rely on *Neblett* to urge that the Rehabilitator has abused her discretion in fashioning a plan which affords to interested persons less rights than those they would enjoy in liquidation. Without conceding that the proposed Plan has this effect, the Rehabilitator agrees that *Neblett* requires claimants be treated the same or better than in liquidation. We shall not belabor this point except to agree with the parties that the Plan must also be viewed in the light of this principle.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors contend that the Plan unlawfully impairs their various contractual rights. This Court finds that these alleged impairments are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided.

The Act and caselaw implicitly recognize that contractual terms are not sacrosanct when an insurance company is insolvent. *See Vickodil v. Insurance Department,* 126 Pa. Commonwealth Ct. 390, 559 A.2d 1010 (1989). As in public utilities, the insurance industry is subject to particularly strict regulation by state government because the impact of an insolvent insurer's contracts is not limited to the named parties. *See Energy Reserves Group, Inc. v. Kansas Power & Light Co.,* 459 U.S. 400, 103 S.Ct. 697, 74 L.Ed.2d 569 (1983). This is particularly applicable to the contracts for reinsurance without which Mutual Fire would have been unable to expand its business. Rather, those contracts entered into by Mutual Fire have affected thousands of members of the public. Of course, individual parties to those contracts cannot be expected to protect this public interest. Thus, the General Assembly, pursuant to its inherent police power to safeguard the public interest, has authorized the Commissioner to represent these interests in order to minimize the harm to all affected parties – insureds, creditors and the public generally – from the potentially devastating consequences of insurance insolvency. 40 P.S. § 221.1. If the Commissioner determines that rehabilitation, as opposed to liquidation, is the most efficient means of representing these interests, and this Court finds no abuse of her discretion, then contractual impairments that are insubstantial and reasonably necessary to implement a rehabilitation plan cannot be deemed unlawful. *Energy Reserves Group.* "[A]n impairment may be constitutional if it is reasonable and necessary to serve an important public purpose." *U.S. Trust Co. of New York v. New Jersey,* 431 U.S. 1, 25, 97 S.Ct. 1505, 1519, 52 L.Ed.2d 92 (1977). We are convinced that Mutual Fire's rehabilitation serves an important public purpose. Hence, we examine the "extent of impairment[s]" to determine their reasonableness. *Id.* at 27, 97 S.Ct. at 1520.

Except for the Plan modifications outlined in this opinion, the Court finds that the alleged contractual impairments are insubstantial and reasonably designed to enable the Commissioner to satisfy all claims in an equitable and orderly manner.

SETOFF

The Plan as now proposed contains, in effect, three definitions of offset. The first provides that mutual debt and credits are only those Due and Owing[11] on December 31, 1986. The optional definition, which may be elected by reinsurers who are also cedents by paying the amount due and owing Mutual Fire within ninety days of plan approval, is the lesser of Mutual Fire's obligation to a cedent for Due and Owing, plus reported case reserves, plus Incurred But Not Reported ("IBNR") losses as of March 31, 1986, *or* the cedent's obligation to Mutual Fire for balances due and owing, plus case reserves as of December 31, 1986. Lastly, insurers paying Due and Owing within ninety days of Plan approval will receive a 10% discount if they waive any and all rights to setoff.

We will examine the optional setoff definition contained in Section III.E.2, the definition most generous to Mutual Fire's creditors according to the record, Rehabilitator's Exhibit No. 4, 7/25/89, on the assumption that those creditors using the more restrictive definition have consented to do so.

[4] We first note that Article V's rehabilitation section contains no definition of setoff while the liquidation provision does. We have already stated that this evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings. *Muir*. If the Rehabilitator's formulation of a plan is not arbitrary or unreasonable, then that plan should be approved if it does not diminish the rights a creditor would have in liquidation.

The Plan's treatment of rights of setoff, found not only in specific contracts but also in common law, must be modified as follows.

[5] Section III.E.2a, pertaining to setoff by reinsurers who are also cedents, shall read so as to compute balances as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these

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11. The term "Due and Owing" is in turn defined as reinsurance recoverable on *paid* losses, *paid* loss adjustment expenses, claim settlement and reimbursement agreements. Section I.II of the Plan (emphasis added).

objectors' rights would be fixed as of that filing date. Section 520(d) of the Act, 40 P.S. § 221.20(d). Thus, this Plan modification assures that those objectors receive substantially the same setoff rights and treatments they would receive in a liquidation.

[6] Section III.F, placing a $25,000,000 cap on total allowable setoff is stricken. There is no provision for a maximum setoff allowance in liquidation proceedings and no legal justification for this restriction.

[7] Further, the Plan's provisions, proclaiming Mutual Fire's books and records to be conclusive, are stricken. Due to the established inaccuracy of Mutual Fire's records, this condition substantially impairs the objectors' right to an accurate accounting. Therefore, the Plan is modified to provide that the figures in Mutual Fire's books may be contested through the Plan's claims and disputes resolution procedures.

PRIORITY OF DISTRIBUTION

A. Cut-off Date for Submission of Class 4 Loss Claims

[8] The Policyholders Committee and (not surprisingly) individual policyholders whose businesses expose them to a "long tail" of liability, object to June 30, 1991, as the cut-off date for recognition of loss claims. The Plan as proposed provides that all such claims reported thereafter will be included in Class 8 ("late claims") priority.

We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitator to submit a recommendation as to whether the date should be extended.

B. Lenders as Policyholders

[9] Six of the ninety-one banks and financial institutions which participated in the Mutual Fire surety bond program have jointly objected to their placement in Class 5 of the Plan's distribution schedule. Known informally as "the Lender Group," these lenders have put forth their view that the surety bonds are insurance policies, entitling them to treatment under the Plan as Class 4 policyholder recipients.

This theory has engendered much controversy in these proceedings, and its proponents as well as opponents have referred us to a wealth of authority for their respective positions. Despite this, our research has revealed no Commonwealth precedent which holds squarely that a surety bond is (or is not) an insurance policy. Thus, we view this as an issue of first impression. For the reasons which follow, we conclude that participants in Mutual Fire's surety bond program are not entitled to the same treatment as Class 4 claimants.

First, we acknowledge the fundamental differences pointed out to this Court between bilateral contracts of insurance and tripartite surety bond agreements. Unlike insurance policies, surety bond premiums are not determined by the insurer on the basis of loss but rather on the lender's evaluation of risk. Premiums are paid not by the lenders but by the investors; they are paid "up-front" and are not subject to adjustment. The instruments have no fixed terms and no right of cancellation or renewal. These factors support the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance.

Second, we do not find it dispositive that the issuance of these bonds is regulated by the Insurance Department. *Group Life & Health Insurance Co. v. Royal Drug Co.*, 440 U.S. 205, 99 S.Ct. 1067, 59 L.d.2d 261 (1979); *see also Backman, Surety Rate-Making* (1948). If, as the lenders argue, the best evidence of the lenders' policyholder status is provided by the bond instrument itself, then there is ample argument in the instrument's title, "Financial Surety Bond for Limited Partnerships," to counter the notion that the use of the term "policy" in the documents render them insurance contracts. Regardless, we

must look beyond these contradictory references and any other nomenclature contained therein to examine the essence of these transactions. We adopt, as has the United States Supreme Court, "the usual view, grounded in commercial practice, that suretyship is not insurance." *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 140 n. 19, 83 S.Ct. 232, 236 n. 19, 9 L.Ed.2d 190 (1952); *see also American Insurance Association v. Clarke*, 656 F. Supp. 404 (D.C. 1987) (municipal bond "insurance" is a bank credit transaction functionally equivalent to a standby letter of credit).

Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those of policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

We find that, even if these bonds were contracts of insurance, the legislature has excluded them from coverage under The Pennsylvania Insurance Guaranty Association Act, Act of November 25, 1970, P.L. 232, as amended, 40 P.S. §§ 1701.101-1701.605. This exclusion evidences an intent not to afford surety holders the protections given by this Act to consumers of insurance whose carrier becomes insolvent.

For these reasons, we conclude that participants in the surety bond lender program would not fall within the same claimant class as "direct book" policyholders were Mutual Fire in liquidation. Thus, their rights are not diminished by their placement in Class 5 of the Plan's distribution schedule. Accordingly, we approve Section II.E of the Plan.

C. Creation of Class 6 and Class 6 Fund

[10] The Lender Group has objected to the creation of a segregated Class 6 fund to be funded by the deposit of 25% of all reinsurance Mutual Fire collects. No portion of this fund shall be paid unless and until this Court enters an Order authorizing initial distribution, and until Class 4 loss claims are paid in full.

The Lender Group, who stands to receive distributions in Class 5 before general creditors in Class 6, argues that this set-aside is inequitable and renders them a sub-class of creditors junior to general unsecured creditors (i.e., principally cedents), in violation of the Act's liquidation provisions.

However, these Class 5 lenders, who fall immediately behind the Class 4 policyholders but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the Plan. Since under the Act the lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class 6 segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett*.

In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute that that consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in this proceeding.

D. United States Claims

[11] United States claims are treated under the Plan as Class 7 claims. The United States government objects to the Plan because it does not accord first priority of payment of debts due the United States. It is asserted that this treatment violates 31 U.S.C. § 3713 (1983), known as the Federal Priority Act, which requires that a United States government claim "shall be paid first when . . . a person indebted to the Government is insolvent. . . ."

The Rehabilitator counters that the Federal Priority Act is inapplicable to these proceedings because the McCarran-

Ferguson Insurance Regulation Act, 15 U.S.C. § 1012 (1976),[12] precludes the impairment or invalidation of state insurance law by any federal statute.

Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United States government claims. We further direct her to report to this Court the amount contained in this set-aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.

First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation (FSLIC) receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against insureds of Mutual Fire; and (3) claims made by Westinghouse Electric Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

Second, although we need not decide today whether the McCarran-Ferguson Act applies to preclude the application of the Federal Priority Act, we have already recognized that the Commonwealth's Insurance Company Law governing rehabilitations is, as was said in *SEC v. National Securities, Inc.*, 393 U.S. 453, 89 S.Ct. 564, 21 L.Ed.2d 668 (1969), "aimed at protecting or regulating this relationship [between insurer and insureds] directly or indirectly." *Id.* at 450, 89 S.Ct. at 569. Thus, Article V would be deemed a law regulating the "business

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12. 15 U.S.C. § 1012(b) provides, in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance. . . ."

of insurance." *Id.*[13] If, after all, liquidation of insolvent insurance companies were not the business of insurance relegated to the states' governance by McCarran-Ferguson, the federal Bankruptcy Code would obviate the need for this statute and similar acts in other states. Hence, McCarran-Ferguson would appear to preclude the application of the Federal Priority Act.

E. Judgment Creditors

[12] Pepsi-Cola Bottling Company of Charlotte, Incorporated, (Pepsi-Cola), has objected to the Plan on the ground that as a federal court judgment holder against Mutual Fire, it is entitled to elevated priority when distributions are made to Class 4 policyholders. Although we agree that this judgment is binding on and cannot be altered by the Rehabilitator, Pepsi-Cola points to no authority – and we have found none – for the position that it is entitled to payment before other policyholders.

Neither the rehabilitation nor liquidation provisions of Article V sets forth any priority for judgment creditors. On the contrary, the serving of a judgment does not elevate the status of such claims. *Davis v. Commonwealth Trust Co.,* 335 Pa. 387, 7 A.2d 3 (1939).

Accordingly, we approve Section II of the Plan as modified, consistent with our determination that a set-aside be provided for United States government claims.

LOSS ADJUSTMENT EXPENSES

No less than fifteen claimants have objected to the Plan's provision for the equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989.

We are painfully aware of the magnitude of this – the largest current expense of the estate – and of the drain it causes

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13. Notwithstanding the Ninth and Fourth Federal Circuit decisions to the contrary, we note the Third Circuit has stated that state-regulated insurance insolvencies are the business of insurance authorized by McCarran-Ferguson. *Lac D'Amiante Du Quebec, Ltee v. American Home Assurance Co.,* 864 F.2d 1033 (3d Cir. 1988), citing *United States Auto. Association v. Muri,* 792 F.2d 356 (3d Cir. 1986), cert. denied, 479 U.S. 1031, 107 S.Ct. 875, 93 L.Ed.2d 830 (1987).

on Mutual Fire's resources. Most, if not all, of the retainers and employment agreements were negotiated by Mutual Fire or its authorized agents prior to its suspension and rehabilitation. It stands to reason that those persons did not have the same incentive to economize which representatives of an insolvent estate necessarily possess. Everyone now, though, must recognize the changed circumstances which have led to this rehabilitation proceeding.

Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.

At the same time, we will further Order the Rehabilitator to review all employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth repeating, that each dollar expended in administrative and unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be undertaken forthwith.

PROPORTIONAL PAYMENTS METHOD

[13] The Rehabilitator proposes,[14] as part of the Plan's proportional payment methodology, to make the first distribution to pay "small claims" – those of $5,000 and under – "as soon as practicable following the effective date of this Plan." We view this innovation an effective and expeditious means of carrying out the Rehabilitator's statutory mandate and find it to

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14. This proposal was also embodied in the Rehabilitator's motion for authority to pay small claims filed August 11, 1989.

be an "equitable apportionment of unavoidable loss." Consequently, we approve it but with the following modifications.

We will require the Rehabilitator to make payments under this distribution no later than June 1, 1990. We will also require the Rehabilitator to submit a schedule of payments made under this provision of the Plan and direct her to establish a schedule of distribution dates which she deems appropriate. Additionally, we will modify the Plan so that payment of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program. We agree with the Policyholders Committee that this latter modification will minimize the preference otherwise given to policyholders with multiple small claims.

The Policyholders Committee also urged us to allow small claims payment only to those claims not adjusted as of the Plan approval date. Underlying this argument is the rationale that immediate adjustment and payment of small claims will save the estate costs concomitant with the continuing management of the outstanding, unadjusted claims. While this rationale applies in part to the Rehabilitator's proposed methodology, we believe such a distinction is inequitable and punishes those claimants who have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings. We will, therefore, approve the payment of small claims whether adjusted or unadjusted as of this date.

MISCELLANEOUS PROVISIONS

A. Jurisdictional Statement

[14] Article V defines the Commonwealth Court's jurisdiction. "No court of this Commonwealth shall have jurisdiction to entertain, hear or determine any delinquency proceeding other than as provided in this article." Section 504 of the Act, 40 P.S. § 221.4.

The statute contemplates that the Commissioner shall petition this Court for rehabilitation and thereafter be appointed statutory rehabilitator. 40 P.S. § 221.15. The Commissioner, as Rehabilitator under the Court's supervisory aegis, is empowered

to "pursue all appropriate legal remedies on behalf of the insurer." 40 P.S. § 221.16(c).

In any court in this state before which any action is pending when a rehabilitation order is entered, the Rehabilitator may request a stay. 40 P.S. § 221.17(a). This Court then shall order the Rehabilitator to take such action in that "pending litigation as the court deems necessary . . ." *Id.*

Thus, the plain language of the statute provides for the Commonwealth Court's exclusive jurisdiction over delinquency proceedings themselves, while recognizing that other courts have jurisdiction over pending proceedings by or against an estate in rehabilitation. Although the Rehabilitator refers us to decisions in other jurisdictions which found an *implied* grant of exclusive jurisdiction to the receivership court,[15] we are not permitted to ignore the statute's plain language in a search for legislative intent.

We disagree with the Rehabilitator that the jurisdictional provision contained in the present Plan is nearly identical to that the Court approved on May 18, 1987. Sections VIII(c) and (e) differ in material respects and we will strike them in whole or in part. Sections (a), (b), (d), (f) and (g) comport with Article V's grant of exclusive jurisdiction in *delinquency* proceedings because they invoke our exclusive jurisdiction in this Commonwealth over matters connected to interpretation of the Plan – and implementation of the rehabilitation itself – including its provisions for asset collection and claims disputes. We therefore approve them.

Likewise, we approve Section X.A, governing disputes other than claims subject to arbitration. We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration.

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15. *In the Matter of Allcity Insurance Co.*, 66 A.D.2d 531, 413 N.Y.S.2d 929 (1979) and *United States v. Bank of New York & Trust Co.*, 296 U.S. 463, 56 S.Ct. 343, 80 L.Ed. 331 (1936) (adopting New York Court's construction of state law in *People by Beha v. Russian Reinsurance Co.*, 255 N.Y. 415, 175 N.E. 114 (1931)).

B. Committee Dissolution

[15] The Rehabilitator has in the Plan proposed that the Policyholders Committee appointed January 28, 1987, by the Court be dissolved.[16] This Court, by Order of November 22, 1989, so dissolved the Committee.

Notwithstanding the Committee's argument that policyholders as a class would thereby be without representation, we took this action for the following reasons.

Primarily, the rehabilitation state conveys to the Rehabilitator the authority and the *duty* to protect the interests of Mutual Fire's insureds. 40 P.S. § 221.1(c). The Rehabilitator has taken possession of Mutual Fire's assets and, by her deputies, continues to administer its business and property, "under the orders of the Court." 40 P.S. § 221.15(c). In instances where she deemed it necessary she has pursued (and will pursue) litigation on behalf of Mutual Fire. She has now proposed a Plan which upon examination and as modified, we find gives due consideration to Mutual Fire's policyholders and other creditors as well.

In addition, the Rehabilitator has petitioned for the establishment of a program to pay outstanding claims under $5,000; a provision for "hardship" claims; and a proportional payment methodology. These procedures, as now modified in the Plan, will protect those policyholder (and claimants) with little or no recourse except to Mutual Fire insurance. Thus, the most damaging exposure to small, "mom and pop" policyholders has been minimized. As the Policyholders Committee has repeatedly stated in its numerous motions and briefs, the rationale underlying its existence and functions is to protect the policyholder class.

Thus, we conclude that the need this Court perceived when equitable considerations dictated the Policyholders Committee's formation no longer exists. Consequently, we find that this cost to Mutual Fire's diminished estate can no longer be justified.

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16. The Rehabilitator by motion of April 6, 1989, had previously asked this Court to suspend payment of the Policyholders Committee's counsel fees and costs. Because of our determination of this Plan provision, we will now dismiss this motion as supererogatory.

Moreover, dissolution of the Committee does not leave policyholders unrepresented. As we have stated, the Rehabilitator is statutorily charged with that duty. Moreover, dissolution of the Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's aegis, as have the other creditors' groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Accordingly, we approve Section XVI.I of the Plan.

C. Immunity Provision

[16] Because no provision for immunity contained in the Plan can *in any case* confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Sections 8501-8528 and 8541-8564 of the Judicial Code, 42 Pa.C.S. §§ 8501-8528; 8541-8564, we will strike this section of the Plan as superogatory. We emphasize that we do not by this action decide the question of the Rehabilitator's immunity.

D. Indemnification Agreement

The Policyholders Committee has also, by separate motion,[17] sought disapproval of certain employment agreements which the Rehabilitator has entered into in connection with her powers under 40 P.S. § 221.16(a) and (b). The Policyholders Committee would have us disapprove the employment of more than one deputy and strike those parts of any agreements containing indemnification provisions for appointed deputies and other employees.

[17] However, the above-mentioned section of Article V gives the Rehabilitator express power to "appoint a special deputy who shall have all the powers of the rehabilitator" and who shall "serve at the pleasure of the commissioner." In addition, the Rehabilitator "shall have full power to direct and

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17. Policyholders Committee Objection, March 9, 1989.

manage, to hire and discharge employes . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

[18] Next, the Policyholders Committee refers to authority which it argues would require us to find indemnification agreements between the Rehabilitator and her deputies void as against public policy. Relying on *Hodgson's Estate,* 342 Pa. 250, 20 A.2d 294 (1941), and *Dilks v. Flohr Chevrolet,* 411 Pa. 425, 192 A.2d 682 (1963), the Policyholders Committee maintains that the indemnity contract to which it objected cannot be entered into because its terms exempt one charged with public service from liability. We find the Committee's arguments unpersuasive in this rehabilitation context, however.

First, *Hodgson's Estate* decided issues raised in testamentary trust litigation. While there is some analogy between an executor or administrator and the Rehabilitator's deputies in this rehabilitation, it has been noted that a receiver's possession of assets is not precisely that of a trustee, but is merely a figurative way of stating that the receiver must hold the property for the benefit of others, albeit in a fiduciary capacity.[18]

We also note that *Miller v. Jacobs,* 361 Pa. 492, 65 A.2d 362 (1949), another testamentary estate decision on which the Policyholders Committee relies, stated the general rule that estate administrators are liable individually but "[w]hether the executor or administrator may have *indemnity* out of the estate is of no concern to third persons." *Id.* at 495 n. 1, 65 A.2d at 364 n. 1 (emphasis added).

Nor does *Dilks* stand for the proposition that *exculpatory* clauses, which may be voided as against policy, *Boyd v. Smith,* 372 Pa. 306, 94 A.2d 44 (1953), and indemnity provisions receive the same treatment under Pennsylvania law. Rather, we find persuasive the Third Circuit's reasoning in *Jamison v. Ellwood Consolidated Water Co.,* 420 F.2d 787, 789 (3d Cir. 1970):

> The difference between . . . [exculpatory clauses and indemnity agreements] is manifest and significant. A valid

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18. Couch on Insurance 2d (Rev. 3d. 1984) § 22:45.

> exculpatory clause precludes recovery by the victim of the negligence. In contrast, a valid indemnity provision in no way affects the victim's right of recovery . . . The Dilks opinion shows an awareness that indemnity and exculpatory clauses are sufficiently similar that the same rules of construction may often be used. However, Dilks clearly did not go so far as to say that the public policy considerations determinative of the legality of exculpatory clauses are necessarily determinative of the legality of indemnity clauses.

On the contrary, the Rehabilitator's action in agreeing to indemnity is reasonably related to public policy considerations governing insurance company rehabilitation.

The necessity of finding experienced and competent deputies is recognized by the statute. "The commissioner shall make such arrangements for compensation as are necessary to obtain a special deputy of proven ability." 40 P.S. § 221.16(a).

In order to attract persons of proven ability, that necessity dictates that those persons by somehow insulated from the fears and costs of possible litigation by naturally disgruntled claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties. We therefore by Order of March 17, 1989, approved the Rehabilitator's request for this employment agreement.

CONCLUSION

Having considered all objections and found that the proposed Plan, with modifications, constitutes an equitable apportionment of unavoidable loss, is in the best interests of insureds and other creditors, and does not constitute an abuse of the Rehabilitator's discretion, we modify the Plan consistent with this opinion and approve it in all other respects.

ORDER

The Rehabilitator's January 31, 1989 Plan of Rehabilitation in the above-captioned matter is modified as follows:

1. The Rehabilitator shall set aside funds which she deems adequate to satisfy any and all possible debts due to the United States Government from The Mutual Fire, Marine and Inland Insurance Company's (Mutual Fire) estate. The Rehabilitator shall advise the Court when this amount is determined and describe the nature of the potential claims for which funds have been set aside. The Rehabilitator shall also notify the United States Government of its determination.

2. Section II.J. is amended to read:

J. Class 10: Owners, Officers and Directors

To the extent of cash available after full payment of all Class 8 claims, payments shall be made to Policyholders as of December 4, 1986, other than in their capacity as Class 4 claimants, in proportion to the annual premiums for the policies then in force.

3. Section III.D., first paragraph, is amended to read:

Setoff for purpose of this Plan shall be calculated as of December 4, 1986. No setoff shall be allowed or paid in those situations described in 40 P.S. § 221.32(b)(1) through (4). Within ninety (90) days of final approval of the Plan, the Department shall notify each creditor of the amount of setoff as calculated by the Rehabilitator. This notice shall contain a statement advising each creditor that it shall have thirty (30) days from receipt of said notice to object to the Rehabilitator's calculation, or that calculation shall be deemed final. In the event of an objection, the dispute shall be resolved pursuant to the Claim Resolution Procedures set forth in Section VII of this Plan.

4. Section III.E.2. is amended to read:

a. Mutual Fire's obligation to the Cedent for: balances Due and Owing, plus reported Case Reserves, plus reported IBNR.

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire for: balances Due and Owing, plus Case Reserves.

All as computed as of December 4, 1986.

Mutual Fire's IBNR is specifically excluded from section (b.) of this calculation.

To the extent that Case Reserves are set off and the claims relating to those case reserves ultimately are settled at a value less than the reserved amount, Reinsurer who is also a Cedent shall remit, in cash, the balance to Mutual Fire.

5. Section III.F. of the Plan is stricken in its entirety.

6. Section VI.A. is amended to read: Interim Partial Payments

Interim Partial Payments shall be made periodically on Class 4 adjusted claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as cash is available, in the manner set forth below.

1. The first distribution to Class 4 shall be made as soon as practicable following the effective date of this Plan, but no later than December 1, 1990. The rehabilitator shall pay after the effective date Class 4 claims of $5,000.00 or less per adjusted claim as and when adjusted out with the first payment not later than June 1, 1990.

2. Unless otherwise Ordered by the Court, distributions shall thereafter be made to Class 4 adjusted claims at least annually.

3. Payments of Class 4 claims to Class 4 claimants with more than one claim under $5,000.00 shall be treated as advances against distributions under the Proportional Payments Method described herein. No Class 4 claimants who receive payment for multiple

small claims shall receive distribution under the Proportional Payment Method until all the Class 4 claimants first receive an equal percentage distribution on their adjusted claims.

7. Section VI.C.1.b. is amended to read:

b. The first distribution respecting claims adjusted between Record Dates ("later-Adjusted Claims") shall cause each such Claim to receive an amount equal to the cumulative percentage paid on earlier Adjusted Claims as of a given Record Date shall receive, on a cumulative basis, proportionally equal distributions as of each Distribution Date.

8. Section VI.C.4. is amended to read:

Upon notice as the Court shall require, all assets held and segregated pursuant to this Section VI by the Rehabilitator, after Class 4 Claims are paid in full or reserved for payment in full, shall be released for payment to Classes 5 through 10.

9. Section VII, second paragraph, is amended to read:

Whenever objections are filed and served, the Rehabilitator shall seek a hearing and give notice of the hearing by first class mail to the Claimant or its attorney not less than thirty (30) days before the date of the hearing. The matter may be heard by the Court or by a court-appointed referee or master who shall submit findings of fact along with his recommendation. Claimants shall cooperate with the Rehabilitator in an effort to settle and adjust Claims.

10. Section VIII.(c) is modified to read:

(c) to hear, determine and where appropriate refer to arbitration, all disputes concerning Claims and the collection of assets of Mutual Fire, including reinsurance and retrocessions;

11. Section VIII(e) is stricken.

11(A). The second paragraph of Section IX Loss Adjustment Expenses is amended to read:

> Loss Adjustment Expenses related to the employment of all investigators, adjustors and counsel who are retained by the Rehabilitator or Mutual Fire or either of their authorized agents to investigate, adjust and defend Claims asserted against Mutual Fire's Policyholders ("Professionals") shall be shared equally by Mutual Fire and its Policyholders effective April 23, 1990. The Rehabilitator reserves the right to further reduce or terminate payment of Loss Adjustment Expenses in the event that cash flow is inadequate. Loss Adjustment Expenses will be paid as aforesaid by Mutual Fire only if Policyholders pay their share of Loss Adjustment Expenses and retain the services of professionals previously approved or hereafter approved by the Rehabilitator.

12. Section XIII.B. is amended to read:

> No action at law or equity shall be brought against Mutual Fire or the Rehabilitator or any employee, agent or representative of the Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further prosecuted, nor shall any counterclaim or setoff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Courts.

The last sentence of Section XIII.B. is stricken.

13. Section XVI.B. is amended to read:

B. Financial Reports

The Rehabilitator shall submit to the Court an annual budget for each year. The Rehabilitator shall also file quarterly financial reports with the Court showing Mutual Fire's current financial condition, a

balance sheet, an income statement, a cash flow statement, a statement of operating and administrative expenses. The Rehabilitator shall also file status reports on reinsurance and asset collections, claims reported and adjusted, and such supporting schedules as are necessary to present Mutual Fire's financial condition fairly.

14. The Plan, including each provision except where amended by this Order, is approved in all other respects.

APPENDIX C

C-1

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, Insurance Commissioner of the Commonwealth of Pennsylvania,	:	
Plaintiff,	:	No. 3483 C.D. 1986
v.	:	
THE MUTUAL FIRE, MARINE & INLAND INSURANCE COMPANY,	:	
Defendant.	:	

ORDER

AND NOW, this 8th day of December, 1986, upon consideration of the stipulation entered into by the parties, it is hereby ordered and decreed that Insurance Commissioner George F. Grode or his successor in office is appointed Rehabilitator of The Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire") with full powers and duties as provided by and in accordance with the Insurance Department Act of 1921, Act of May 17, 1921, P.L. 789, *as amended,* 40 P.S. §§ 221.1-221.63.

It is further ordered and decreed that the Insurance Commissioner's Suspension Order dated September 13, 1986, continues to be in full force and effect except to the extent that that Order impairs the powers of the Rehabilitator as set forth in the Insurance Department Act.

No action at law or equity, except for the *Mutual Fire Company v. NORAD and GTE* federal arbitration hearing, shall be commenced or prosecuted nor shall any judgment be entered against nor shall any execution or attachment be issued or prosecuted against Mutual Fire and/or the Rehabilitator until further order of this Court.

It is further ordered and decreed that the notices of the filing of the Plan of Rehabilitation are approved.

A hearing on approval of the Plan of Rehabilitation shall be held at 10:00 a.m. on the 18th day of December, 1986, in Courtroom No. 6, Second Floor, Robert N.C. Nix, Sr., Federal Building, Chestnut Street at Ninth, Philadelphia, PA.

(James Crumlish, Jr.)
James Crumlish, Jr.
President Judge

APPENDIX D

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,	:	
Plaintiff,	:	No. 3483 C.D. 1986
v.	:	
THE MUTUAL FIRE, MARINE & INLAND INSURANCE COMPANY,	:	
Defendant.	:	

M E M O R A N D U M
and
O R D E R

Before this Court are the application for supersedeas or stay pending appeal filed by a group of Reinsurers (Reinsurers)[1] and Allstate Insurance Company's (Allstate) motion for stay pending appeal of this Court's January 23, 1992 Order approving as modified the Commonwealth Insurance Commissioner's 1989 Plan of Rehabilitation (Plan) for The Mutual Fire Marine and Inland Insurance Company (Mutual Fire). The Rehabilitator has filed responses to both the application and motion. For the reasons which follow, we deny the application and the motion.

A stay of proceedings will be granted if:

1. The petitioner makes a strong showing that he is likely to prevail on the merits.

---

1. GTE Reinsurance Company, Ltd.; Republic Insurance Group; Winterthur Reinsurance Corporation of America, f/k/a in the United States as Winterthur Swiss Insurance Company, U.S. Branch; the Reinsurance Corporation of New York; NAC Reinsurance Corporation; and Christiania Genèral Insurance Corporation.

2. The petitioner has shown that without the requested relief, he will suffer irreparable injury.

3. The issuance of a stay will not substantially harm other interested parties in the proceedings.

4. The issuance of a stay will not adversely affect the public interest.

Pennyslvania Public Utility Commission v. Process Gas Consumers Group, 502 Pa. 545, 552-53, 467 A.2d 805, 808-89 (1983). When the latter three factors strongly favor interim relief, a court may exercise its discretion to grant a stay if the movant has made a substantial case on the merits. *Id.*

Turning to applicants' argument that they will suffer irreparable injury without a stay, we find, on the contrary, that the economic harm averred is speculative and not irreparable. Allstate contends that, without a stay, the collateral used to secure certain obligations in which it has an interest may be used to satisfy claims. Allstate maintains that this will result in a loss of the collateral that will be virtually impossible to regain. However, to the extent that Allstate is holding collateral in excess of funds needed to secure obligations, there is no harm, because under Section 503, Article V of the Insurance Department Act of 1921 (Law), P.L. 789, *as amended,* added by Section 2 of the Act of December 14, 1977, P.L. 280, *as amended,* 40 P.S. § 221.3, excess collateral is an asset of Mutual Fire's estate. The Plan as modified and approved and, if implemented, would not require Allstate to relinquish collateral necessary to secure obligations under any agreement between Mutual Fire and Allstate. Moreover, any dispute over whether certain amounts of collateral are in excess can be resolved through the dispute resolution procedure provided by Section X of the Plan. Other than collateral which is determined to be excess, Allstate's security interest is not disturbed.

We are also not persuaded by Reinsurers and Allstate's contention that they will be irreparably harmed if the Rehabilitator implements the Plan's current setoff calculation pending a decision on its propriety.

Any adjustment to the setoff definition which would result from the Reinsurers and Allstate's successful appeal of the Plan's setoff provision would require no more than an adjustment to the setoff amounts now established. Testimony and documentary evidence presented at hearing on the Rehabilitator's motion for approval of the Plan indicated that the proposed payment of over 800 small claims (those under $5,000, Sections II.D and VI, 4.1. of the Plan) will result in significant *savings* to the estate. N.T., July 25, 1989, pp. 70-73; Rehabilitator's Exhibit 3. If implementation of the Plan is stayed pending appeal, the estimated $10 million in these administrative savings resulting from small claims payment will be lost. Hence, this Court is satisfied that, notwithstanding a disbursement of monies in payment of small claims, sufficient assets (including reinsurance recoverables) will be preserved to make an adjustment to setoff if the Reinsurers' rights to setoff are modified in their favor.

Moreover, the issuance of a stay at the behest of Allstate and the Reinsurers will substantially harm those small policyholders who have an interest in completion of the rehabilitation and who stand to receive payments of less than $5,000 by June 1990. As we have stated previously, these parties, who have been without recourse to their insurer since 1986, can least afford to bear the brunt of delay and its consequent diminution of estate assets. Indeed, all parties continue to suffer each day implementation of the plan is postponed.

Immediate implementation of the plan does not mean immediate and irretrievable dissolution of all assets. It can be assumed that the Rehabilitator will perform her official duties pursuant to the Plan and the Law's rehabilitation provisions with due regard for the affects of the various appeals and the rights of all parties. She will proceed with implementation only to the extent necessary to conserve estate assets and preserve the rights adjudicated in this Court's Order approving the Plan.

Thus, the latter three *Process Gas* factors to be considered in acting on a stay request do not favor interim relief. If such relief *were* warranted, we nonetheless conclude that Allstate and the Reinsurers have not shown they are likely to succeed on the merits of their appeals.

The Reinsurers contend that the Plan erroneously prohibits offset of premium owed *by* Mutual Fire. However, each of the Reinsurers seeking a stay, except Christiana General Insurance Corporation, both reinsured and *were reinsured* by Mutual Fire. In this context, in which Mutual Fire is both an insured and insurer, and where mutuality is required in any event, the Law's liquidation provision plainly prohibits setoff where "the obligation of the person [i.e., Mutual Fire] is to pay premiums, whether earned or unearned, to the insurer [i.e., Reinsurers]." 40 P.S. § 221.32. Setoff in liquidation is not allowed where Mutual Fire's obligation as an insured is to pay premiums on business to reinsurers. Thus, it was within the Rehabiliator's discretion to disallow premium setoff in these rehabilitation proceedings.

Nor is it tenable to contend, as Allstate does, that this Court has no jurisdiction over the trust established by agreement prior to rehabilitation, or that the Commissioner has no authority to administer collateral.

The Rehabilitator is empowered to take possession of general assets of Mutual Fire's estate. "General Assets" are defined in the Law as "all property . . . or its proceeds in excess of the amount necessary to discharge the sum or sums secured thereby." 40 P.S. § 221.3. Thus, excess collateral, if any exists, is a general asset of the estate which may be administered pursuant to a rehabilitation plan and "under orders of the [C]ourt." 40 P.S. § 221.15(c). The Rehabilitator concedes that the Plan does not require Secured Creditors *to forfeit* collateral. The Plan itself states that "each secured claim shall be paid *to the extend of the value of the collateral* which secured said claim or by the release to the secured creditor of any collateral equal to the amount of such secured claim. Any collateral held by a Secured Creditor in excess of the amount to which said Secured Creditor is entitled . . . *shall be turned over to the Rehabilitator.*" (Plan, Section II A., p. 5; emphasis added). Thus, nothing in the Plan is contrary to the rehabilitation or liquidation provisions governing the rights of secured creditors.

In sum, we conclude that Allstate and the Reinsurers have not established that, without a stay, they will be irreparably injured. We further conclude that the issuance of a stay will

substantially harm thousands of policyholders and claimants who have comparatively little or no financial ability to withstand additional delay. A stay would also present a significant impediment to the interest of *all* parties (including Allstate and the Reinsurers) in the expeditious collection and distribution of assets. Finally, we perceive little likelihood that these movants will succeed on the questions they raise on appeal.

Accordingly, we enter the following

ORDER

1. The application for supersedeas or stay pending appeal filed by GTE Reinsurance Company, Ltd.; Republic Insurance Group; Winterthur Reinsurance Corporation of America, f/k/a in the United States as Winterthur Swiss Insurance Company, U.S. Branch; the Reinsurance Corporation of New York; NAC Reinsurance Corporation; and Christiana General Insurance Corporation is hereby denied.

2. Allstate Insurance Company's motion for stay pending appeal is hereby denied.

Date: March 27, 1990

(JAMES CRUMLISH, JR.)
James Crumlish, Jr.
President Judge

APPENDIX E

CONSTITUTIONAL PROVISIONS AND STATUTE INVOLVED

Article I, § 10 – Contract Clause

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

40 P.S. § 221.32 – Setoffs and Counterclaims

(a) Mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).

(b) No setoff or counterclaim shall be allowed in favor of any person where:

(1) the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;

(2) the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;

(3) the obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(4) the obligation of the person is to pay premiums, whether earned or unearned to the insurer.

APPENDIX F

3/7/90
REDACTED

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, Insurance Commissioner of the Commonwealth of Pennsylvania,	:	
Plaintiff,	:	No. 3483 C.D. 1986
v.	:	(Proceedings For Rehabilitation Of A Domestic Insurer)
THE MUTUAL FIRE, MARINE & INLAND INSURANCE COMPANY,	:	
Defendant.	:	

PLAN OF REHABILITATION
Dated January 31, 1989
as Modified by Order Dated
January 23, 1990

This Modified Plan of Rehabilitation is proposed pursuant to 40 P.S. Section 221.16(d) by Constance B. Foster, Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company (the "Plan"). The Plan supersedes all previous plans of rehabilitation proposed and/or confirmed, supersedes any prior inconsistent Orders or agreements and governs the payment and satisfaction of all rights and Claims against the assets of Mutual Fire of all persons interested in the Rehabilitation of Mutual Fire. Such parties shall have no rights or Claims against the assets of Mutual Fire other than as are provided by the Plan.

* * * *

SECTION I.
DEFINITIONS

For purpose of this Plan, and unless the context otherwise requires, the terms set forth below shall have the following meanings:

11. *Due and Owing*. Reinsurance recoverable on paid Losses, paid Loss Adjustment Expenses, Claim settlements and reimbursement agreements.

* * * *

SECTION III
SETOFF

Regardless of any provision in a reinsurance contract or other agreement, mutual debts and credits between Mutual Fire and other persons may be setoff on the following basis:

A. Mutual Debts and Credits

Mutual debts and credits may be setoff only on a company by company basis. For purposes of the Plan, a company shall mean a corporation or other legal entity with independent legal existence, capable or suing and being sued in its own name.

Except as hereinafter provided, mutual obligations may not be aggregated and setoff against each other. If the net amount is owed to Mutual Fire by the other company, it shall be paid forthwith to Mutual Fire in full. If the net amount is owed by Mutual Fire, that amount may be claimed according to the properties of distribution described in Section II of this Plan.

B. Other Obligations

Regardless of any provision in a reinsurance contract or other agreement, obligations to pay premiums to Mutual Fire may not be setoff against other obligations. Premiums owed to Mutual Fire shall be paid forthwith in full.

C. Criteria

Claims are mutual if they satisfy the following criteria:

1. To be mutual, Claims must be mutual at the time the obligations were incurred.

2. Claims do not become mutual by assignment, by reorganization of companies, or by any other means, if the result would be to permit setoff that otherwise would not be available absent such assignment, reorganization or other means.

3. Claims are mutual only if the parties are acting in the same capacity with respect to the Claims they seek to setoff.

D. Setoff Calculated As of December 31, 1986

Setoff for purposes of this Plan shall be calculated as of December 4, 1986. No setoff shall be allowed or paid in those situations described in 40 P.S. Section 221.32(b)(1) through (4). Within ninety (90) days of final approval of the Plan, the Department shall notify each creditor of the amount of setoff as calculated by the Rehabilitator. This notice shall contain a statement advising each creditor that it shall have thirty (30) days from receipt of said notice to object to the Rehabilitator's calculation, or that calculation shall be deemed final. In the event of an objection, the dispute shall be resolved pursuant to the Claim Resolution Procedures set forth in Section VII of this Plan.

The only mutual debts and credits that may be setoff against one another are those Due and Owing on December 31, 1986.

To the extent any Reinsurer who is also a Cedent is permitted a setoff, Mutual Fire shall receive all payments due from the Retrocessionaries that are attributable to the Claims of the ceding company that are satisfied by application of the setoff, and such sums shall not be deposited in the Class 6 Fund.

E. Election of Optional Setoff Definition

1. *Election.* A Reinsurer who is also a Cedent may pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan, in which

event the Optional Setoff Definition set forth below shall apply to said Reinsurer.

2. *Optional Setoff Definition.* The Optional Setoff Definition shall be as follows:

Any Reinsurer of Mutual Fire who is also a Cedent to Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to Mutual Fire according to Mutual Fire's books pursuant to the following calculation:

Option Setoff Calculation – The lesser of:

a. Mutual Fire's obligation to the Cedent for: balances Due and Owing, plus reported Case Reserves, plus reported INBR. All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire balances Due and Owing, plus Case Reserves. All as computed as of December 4, 1986. Mutual Fire's IBNR is specifically excluded from section (b.) of this calculation.

To the extent that Case Reserves are setoff and the claims relating to those case reserves ultimately are settled as a value less than the reserved amount, Reinsurer who is also a Cedent shall remit, in cash, the balance to Mutual Fire.

3. To the extent any Reinsurer who is also a Cedent is permitted a setoff, Mutual Fire shall receive all payments due from the Retrocessionaries that are attributable to the Claims of the ceding company that are satisfied by application of the setoff and such sums shall not be deposited into the Class 6 Fund.

F. Reinsurance Discount

Reinsurers who pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan shall receive a ten percent (10%) discount. In order to qualify for the discount contained herein, a Reinsurer must waive any right to setoff.

APPENDIX G

PRIMARY CASUALTY QUOTA SHARE AGREEMENT

entered into between

MUTUAL FIRE, MARINE AND
INLAND INSURANCE COMPANY
Philadelphia, Pennsylvania

(hereinafter referred to as the "Company")
and
The Subscribing Reinsurer(s) executing
the Interests and Liabilities Agreement(s)
attached to and forming a part of this Agreement

(hereinafter referred to as the "Reinsurer")

ARTICLE I

BUSINESS COVERED, NET RETENTION AND LIMIT OF LIABILITY:

A. The Company will cede and the Reinsurer will be obligated to assume as reinsurance NINETY (90%) PERCENT Quota Share of business classified by the Company as Primary Casualty, under all binders, slips, certificates, contracts or agreements whether oral or written or as other evidences of liability of insurance or reinsurance (hereinafter called "Acceptance" and/or "Policies") inforce, issued, renewed or contracted by or on behalf of the Company on and after the inception of this Agreement.

* * * *

ARTICLE XXII

OFFSET:

"Either party to this Agreement shall have the right to offset any balance or balances due the other under any or all contracts between them; and such right of deduction and offset shall be exercisable without diminution because of insolvency of the Company or Reinsurer, if such be the case.

* * * *

INTERESTS AND LIABILITIES AGREEMENT

(hereinafter referred to as the "Agreement")

to the

PRIMARY CASUALTY QUOTA SHARE AGREEMENT

It is hereby mutually agreed by

MUTUAL FIRE, MARINE AND
INLAND INSURANCE COMPANY
Philadelphia, Pennsylvania

(hereinafter referred to as the "Company")

and

TELECT INSURANCE COMPANY LIMITED[1]

(hereinafter referred to as the "Subscribing Reinsurer")

that the Subscribing Reinsurer shall have a 11.50%, part of 90%, participation in the Interests and Liabilities of the Reinsurer as set forth in the Instrument attached hereto entitled Primary Casualty Quota Share Agreement.

Such participation shall be several and not joint with the participation of other subscribing reinsurers and the Subscribing Reinsurer shall under no circumstances participate in the Interests and Liabilities, (if any) of the other reinsurers in said instrument.

The Company shall pay to the Subscribing Reinsurer 11.50%, part of 90%, of all premiums due or which may become due the Reinsurer in accordance with the provisions of Article VIII of the instrument attached.

This Agreement shall attach at July 1, 1983 Local Standard Time, and is subject to the Term and Cancellation provisions if any, contained in Article III of the attached instrument which are hereby incorporated by reference

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1. GTE Reinsurance Co., Ltd., was known as Telect Insurance Company, Ltd., at the time this contact was signed.

into this Agreement and which shall apply as though they had been specifically provided for herein.

* * * *

IN WITNESS WHEREOF, the parties hereto have caused this Interests and Liabilities Agreement to be signed in duplicate by their duly authorized representatives.

Signed in Philadelphia, Pennsylvania
this 24th day of May, 1986.

MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY

By: (John E. Gannon)

Signed in Hamilton, Bermuda
this 24th day of June, 1984

TELECT INSURANCE COMPANY LIMITED

By: (Robert A. Judson)
ROBERT A. JUDSON
DIRECTOR-REINSURANCE

PNI No. 00034(84)

GENERAL PROPERTY
QUOTA SHARE REINSURANCE CONTRACT

ON BUSINESS PRODUCED BY HULL AND COMPANY, INC.

BETWEEN THE

MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY

(Hereinafter called the "REINSURED")

of the one part

and

* * * *

OFFSET

ARTICLE XIII

1. Each party hereto shall have, and may exercise at any time and from time to time, the right to offset any balance or balances, whether on account of premiums or on account of losses or otherwise, due from such party to the other, (or, if more than one, any other) party hereto under this Contract or under any other reinsurance agreement heretofore or hereafter entered into by and between them, and may offset the same against any balance or balances due or to become due to the former from the latter under the same or any other reinsurance agreement between them; and the party asserting the right of offset shall have and may exercise such right whether the balance or balances due or to become due to such party from the other are on account of premiums or on account of losses or otherwise and regardless of the capacity, whether as assuming Insurer or as ceding Insurer, in which each party acted under the Agreement or, if more than one, the different agreements involved, provided, however, that in the event of the insolvency of a party hereto, offsets shall only be allowed in accordance with

the provisions of Section 538 of the Insurance Law of the State of New York.

* * * *

IN WITNESS WHEREOF, the parties hereto have caused this Contract to be signed, in triplicate, by their duly authorized representatives.

Signed in Philadelphia, Pennsylvania this 18 day of April 1985.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY

BY (J.M. Reilly)

Signed in New York, New York this 10th day of September 1985.

PAN ATLANTIC GROUP, INC. AS UNDERWRITING MANAGER FOR AND ON BEHALF OF REPUBLIC INSURANCE COMPANY, TEXAS.

BY (Marilyn J. Megill)
Assistant Vice President

Having a 28.333% participation hereon.